No. 06-484
Title: Tellabs, Inc., et al., Petitioners
v.
Makor Issues & Rights, Ltd., et al.
Docketed: October 5, 2006
Lower Ct: United States Court of Appeals for the Seventh Circuit
Case Nos.: (04-1687)
Decision Date: January 25, 2006
Rehearing Denied: July 10, 2006
Questions Presented

~~Date~~	~~~~~~~~Proceedings and Orders~~~~~~~~~~~~~~~~~~~~~~
Oct 3 2006	Petition for a writ of certiorari filed. (Response due November 6, 2006)
Oct 24 2006	Order extending time to file response to petition to and including December 6, 2006.
Dec 6 2006	Brief of respondent Makor Issues & Rights, Ltd., et al. in opposition filed.
Dec 6 2006	Brief amici curiae of Securities Industry and Financial Markets Association, et al. filed.
Dec 19 2006	Reply of petitioners Tellabs, Inc., et al. filed.
Dec 20 2006	DISTRIBUTED for Conference of January 5, 2007.
Jan 5 2007	Petition GRANTED. The brief of petitioners is to be filed with the Clerk and served upon opposing counsel on or before 2 p.m., Friday, February 9, 2007. The brief of respondents is to be filed with the Clerk and served upon opposing counsel on or before 2 p.m., Friday, March 9, 2007. A reply brief, if any, is to be filed with the Clerk and served upon opposing counsel on or before 2 p.m., Tuesday, March 20, 2007.
Jan 17 2007	SET FOR ARGUMENT ON Wednesday, March 28, 2007.
Feb 1 2007	Record received from U.S.C.A. for 7th Circuit. (1 box)
Feb 6 2007	Consent to the filing of amicus briefs in support of either party received from counsel for the petitioner.
Feb 6 2007	Consent to the filing of amicus briefs in support of either party party received from counsel for the respondent.
Feb 8 2007	Brief amici curiae of Securities Industry and Financial Markets Associationand Chamber of Commerce of the United States of America filed.
Feb 9 2007	Brief amici curiae of American Institute of Certified Public Accountants, et al. filed.
Feb 9 2007	Brief amicus curiae of Washington Legal Foundation filed.
Feb 9 2007	Brief amicus curiae of New England Legal Foundation filed.
Feb 9 2007	Brief amicus curiae of United States filed.
Feb 9 2007	Brief amici curiae of Joseph A. Grundfest, et al. filed.
Feb 9 2007	Brief amici curiae of Technet, et al. filed.
Feb 9 2007	Brief amici curiae of Pixelplus Co., Ltd. and Quest Software, Inc. filed.
Feb 9 2007	Joint appendix filed.
Feb 9 2007	Brief of petitioners Tellabs, Incorporated and Richard C. Notebaert filed.
Feb 14 2007	CIRCULATED.
Feb 16 2007	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
Feb 28 2007	Record received from U.S.D.C. for Northern District of Illinois. (1 box)

Mar 7 2007	Brief amici curiae of Allan N. Littman and William I. Edlund filed. (Distributed)
Mar 8 2007	Brief amicus curiae of American Association for Justice filed. (Distributed)
Mar 9 2007	Brief amici curiae of Amalgamated Bank, as Trustee for the Long View Collective Investiment Fund, et al. filed. (Distributed
Mar 9 2007	Brief amicus curiae of North American Securities Administrators Association, Inc. filed. (Distributed)
Mar 9 2007	Brief amici curiae of Regents of the University of California, et al. filed. (Distributed)
Mar 9 2007	Brief amici curiae of National Conference on Public employee Retirement Systems, et al. filed. (Distributed)
Mar 9 2007	Brief amici curiae of Ohio and 23 Other States, Territories and Commonwealths filed.
Mar 9 2007	Brief of respondents Makor Issues & Rights, Ltd., et al. filed. (Distributed)
Mar 9 2007	Brief amici curiae of Center for Study of Responsive Law, et al. filed. (Distributed)
Mar 9 2007	Brief amici curiae of German Association for the Protection of Shareholders, et al. filed. (Distributed)
Mar 9 2007	Brief amicus curiae of Council of Institutional Investors filed. (Distributed)
Mar 9 2007	Brief amici curiae of Arkansas, et al. filed. (Distributed)
Mar 9 2007	Brief amici curiae of New York State Retirement Fund, et al. filed. (Distributed)
Mar 16 2007	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED.
Mar 16 2007	Reply of petitioners Tellabs, Inc., et al. filed. (Distributed)
Mar 20 2007	Letter and attachments received from counsel for the respondents. (Distributed).
Mar 28 2007	Argued. For petitioners: Carter G. Phillips, Washington, D.C.; and Kannon K. Shanmugam, Assistant to the Solicitor General, Department of Justice, Washington, D.C. (for United States, as amicus curiae.) For respondents: Arthur R. Miller, Cambridge, Mass.

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No. 06-

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD C. NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether, and to what extent, a court must consider or weigh competing inferences in determining whether a complaint asserting a claim of securities fraud has alleged facts sufficient to establish a "strong inference" that the defendant acted with scienter, as required under the Private Securities Litigation Reform Act of 1995.

PARTIES TO THE PROCEEDING

Petitioners, defendants-appellees below, are Tellabs, Inc., and Richard C. Notebaert. Additional defendants-appellees below are Michael J. Birck, Joan E. Ryan, Brian J. Jackman, Robert W. Pullen and John C. Kohler, all of whom are former officers or directors of Tellabs, Inc. Petitioner Tellabs, Inc. has no parent company, and no publicly held company owns 10 percent or more of Tellabs' shares.

Respondents are Makor Issues & Rights, Ltd, a corporation appointed as lead plaintiff-appellant below, and the individuals Chris Broholm, Richard LeBrun, David Leehey and Patricia Morris, all of whom purport to act on behalf of themselves and a class of all persons similarly situated.

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IN THE

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No. 06-

TELLABS, INCORPORATED AND RICHARD C. NOTEBAERT,
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v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITION FOR A WRIT OF CERTIORARI

Petitioners Tellabs, Inc. and Richard C. Notebaert respectfully request that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit was entered on January 25, 2006. That opinion was modified (on an issue that is not the subject of this petition) by an order entered on July 10, 2006. That Order is included in the Appendix at 118a-119a. The modified opinion is included in the Appendix ("App.") at 1a-27a. It has been officially reported and can be found at *Makor Issues & Rights, Ltd.* v. *Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006). The opinion and order of the United States District Court for the Northern District of Illinois dismissing

respondents' Second Consolidated Amended Class Action Complaint ("Second Amended Complaint") was entered on February 19, 2004, and is included in the Appendix at 28a-79a. That opinion has been reported and can be found at *Johnson* v. *Tellabs, Inc.*, 303 F. Supp. 2d 941 (N.D. Ill. 2004). The opinion and order of the United States District Court for the Northern District of Illinois dismissing respondents' Consolidated Amended Class Action Complaint was entered on May 19, 2003, and is included in the Appendix at 80a-117a. That opinion has also been reported and can be found at *Johnson* v. *Tellabs, Inc.*, 262 F. Supp. 2d 937 (N.D. Ill. 2003).

JURISDICTION

The court of appeals issued its original opinion on January 25, 2006. Petitioner timely sought rehearing, which resulted in an order modifying the original opinion dated July 10, 2006. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254.

STATUTORY PROVISION INVOLVED

Section 21D of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-4, was added by the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 747. Section 21D provides, in pertinent part, as follows:

> (2) REQUIRED STATE OF MIND.—In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

STATEMENT OF THE CASE

This case presents a deep split of authority with respect to what is perhaps the most important provision of a frequently invoked federal statute. The Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 ("Reform Act" or "PSLRA"), was passed by Congress to provide a strict, nationally uniform standard by which complaints alleging securities fraud under federal law would be judged. Congress deliberately chose to require that such complaints plead particularized facts creating a "strong inference" that the defendant acted with the culpable mental state required for liability. 15 U.S.C. § 78u-4(b)(2). Absent compliance with this requirement, litigation is not permitted to proceed past a motion to dismiss, thereby preventing the substantial litigation costs that too often forced defendants in such suits to settle even non-meritorious claims.

More than 10 years later, there is not the clear, uniform standard that Congress envisioned. Scienter is, of course, the culpable mental state required for a claim under Section 10(b) of the Securities Exchange Act of 1934, and is generally proved by inference rather than with direct evidence. *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 391 n.30 (1983). The various courts of appeals have adopted four meaningfully different interpretations of the "strong inference" standard as applied to claims of scienter. There is now a 4-2-2-1 split of authority regarding whether and how a court applying the "strong inference" standard should consider the inferences of an innocent mental state that could be drawn from the complaint's allegations. Only this Court can resolve this important conflict.

The Seventh Circuit, in the case at hand, has determined that in ascertaining whether a "strong inference" of scienter has been adequately pleaded, it will not consider competing inferences of an innocent mental state that may also be drawn from the alleged facts. To consider the strength of innocent inferences as against any potentially culpable inferences at the

pleading stage, the Seventh Circuit reasoned, might "be misunderstood as a usurpation of the jury's role" in potential violation of the Seventh Amendment. Pet. App. 20a. To avoid this possibility, the Seventh Circuit held that a securities fraud complaint should survive "if it alleges facts from which, if true, a reasonable person *could* infer that the defendant acted with the required intent." *Id.* (emphasis added).

Six other circuits allow innocent inferences to play a significant role in evaluating whether a complaint alleges facts from which a "strong inference" that the defendant acted with scienter may be drawn. All of these circuits reject the "could infer" standard of the court below, even as those six circuits disagree on what role reasonable innocent inferences should play in the analysis.

Four circuits—the First, Fourth, Sixth and Ninth—require a direct comparison of the plausibility of competing inferences. These courts have held that a court should consider all the reasonable inferences that might be drawn (both of scienter and of an innocent mental state) and then compare the relative plausibility of the culpable inference to the innocent inference. Unless the culpable inference is the *most* plausible, then it is not "strong" and the complaint should be dismissed. See *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2005); *Ottman* v. *Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 350 (4th Cir. 2003); *Helwig* v. *Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001); *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002).

The Tenth Circuit also considers all the inferences, both of scienter and of an innocent mental state, that may be drawn from the record. *Pirraglia* v. *Novell, Inc.*, 339 F.3d 1182, 1187-88 (10th Cir. 2003). But the Tenth Circuit has expressly declined to follow the view, which it associated with the Sixth Circuit, that only the "'most plausible of competing inferences'" is "strong." *Id.* at 1188. And the Tenth Circuit has ruled that courts should not directly weigh the relative

plausibility of competing innocent and culpable inferences. *Id.* (emphasizing that the Tenth Circuit's approach "does not involve a 'weighing' of the plaintiff's suggested inference against other inferences"). The Tenth Circuit nonetheless considers the innocent inferences to determine "whether plaintiff's suggested inference is 'strong' in light of its overall context." *Id.* The Eighth Circuit considers innocent and culpable inferences similarly. *Florida State Bd. of Admin.* v. *Green Tree Fin. Corp.*, 270 F.3d 645, 666-67 (8th Cir. 2001).

Finally, two courts—the Second and Third Circuits—have adopted an altogether different approach to evaluating whether the "strong inference" of scienter exists. Rather than consider all the allegations together, these courts have divided the allegations relating to mental state into two distinct types, "motive and opportunity" on the one hand, and "strong circumstantial evidence" that a defendant knowingly or recklessly issued false statements on the other, either of which might independently satisfy the "strong inference" standard. *Kalnit* v. *Eichler*, 264 F.3d 131, 138 (2d Cir. 2001); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3d Cir. 1999).

That diverse approaches to the interpretation and application of the "strong inference of scienter" standard currently prevail in the courts of appeals is directly contrary to Congress's intent to create a uniform standard for pleading securities fraud nationwide. See H.R. Rep. No. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740. In addition, the weakened version of the "strong inference" standard adopted by the Seventh Circuit in this case, the most lenient of any circuit, is also inconsistent with Congress's expressed desire to end the pernicious practice of pleading fraud with hindsight whenever a company's stock price tumbles, subjecting businesses to the Hobson's choice of paying out a quick settlement for a baseless claim or incurring massive risk and litigation costs. See S. Rep. No. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683. Only this

Court can clarify the "strong inference" standard—particularly how lower courts should consider inferences that the defendant was innocent—and provide the uniformity that Congress indisputably sought.

A. Nature Of The Case.

Petitioner Tellabs, Inc. is a manufacturer of specialized optical networks and broadband access equipment whose primary customers are telecommunications carriers as well as internet service providers. Petitioner Richard Notebaert was the CEO of Tellabs during the period relevant to this case. Like many of its competitors, Tellabs experienced a decrease in demand for its products during 2001, when the telecommunications and technology sectors suffered a severe contraction. The price of Tellabs shares consequently declined.

As is relevant here, respondents, plaintiffs below, representing a proposed class of Tellabs shareholders, sued Tellabs and several of its officers and directors under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, and Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a). Respondents alleged that defendants had engaged in a scheme to inflate Tellabs' stock price between December 11, 2000 (the date when Tellabs first issued its projections for 2001 revenue) and June 19, 2001 (the date Tellabs withdrew its previous guidance for 2001 revenue and revised its projection of revenue for the second quarter of 2001).[1] In general, respondents alleged that Tellabs improperly booked revenue for the fourth quarter of

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[1] Between those dates Tellabs revised its guidance several times, including decreasing its projected revenue for the first quarter of 2001 by approximately $90 million on April 6, 2001, and, on April 18, 2001, decreasing expected annual revenue for 2001 to an amount that was approximately $800 million less than originally forecast.

2000 and that, during the relevant period, Tellabs' revenue projections for 2001 were false.

As the case arrives at this Court, the relevant factual allegations have been substantially narrowed. And the only allegations of scienter held sufficient to support a Section 10(b) claim are those pertaining to Notebaert.

1. Respondents' claim that Tellabs' fourth quarter 2000 financial statements were intentionally false is based on certain allegations of what they term "channel stuffing." The complaint alleges that Notebaert worked with Tellabs personnel to engage in "channel stuffing" and "unquestionably knew" that "channel stuffing" was occurring. Pet. App. 25a. However, the complaint defines "channel stuffing" to include not only improper conduct (such as writing orders for products customers had not requested), but also conduct that is *not* improper, such as "offering customers discounts of as much as 10% to 20%" and extending credit terms from 30 to 90 days. *Id.* at 58a.

Respondents used this broad definition of "channel stuffing" in the Second Amended Complaint despite having been admonished by the district court, in dismissing an earlier version of the complaint, that "there certainly is nothing inherently wrong with offering incentives to customers to purchase products." Pet. App. 99a-100a. And when the Second Amended Complaint alleges that Notebaert worked with Tellabs personnel to engage in "channel stuffing," and knew that "channel stuffing" was occurring, it does not specify the type of "channel stuffing" activity engaged in by Notebaert; nor does it specify whether it is referring to his alleged knowledge of mere discounts and sales incentives or to the improper shipping of unordered products, both of which respondents lumped together under the term "channel stuffing."

2. As alleged by respondents, the reduction in projected second quarter earnings that Tellabs announced on June 19, 2001—an event that Petitioners characterize as disclosure of

"the truth"—was due almost entirely to a decrease in demand for the TITAN 5500, Tellabs' most popular optical networking product. Pet. App. 4a-5a. The claim that Petitioners falsely inflated Tellabs' projections for 2001 is, in turn, based largely on certain earlier statements that Notebaert made concerning the TITAN 5500.

As recounted by the Seventh Circuit, at various points in February, March and April of 2001, Notebaert made public statements of confidence in demand for the TITAN 5500. Specifically, in the 2000 Annual Report, published on February 14, 2001, Notebaert stated that the TITAN 5500, though ten years old, "'is still going strong.'" Pet. App. 23a. In a conference call with investors on March 8, 2001, Notebaert was asked by an analyst whether Tellabs was experiencing weakness in demand for the TITAN 5500; Notebaert responded that Tellabs was not and that the product was continuing "'to maintain its growth rate.'" *Id.* at 3a. On April 6, 2001, Notebaert told analysts that customers were indicating that "'in-user demand for services continues to grow.'" *Id.* at 23a.

Respondents alleged that Notebaert's statements of confidence in customer demand for the TITAN 5500 were knowingly false because Tellabs had commissioned a report by Probe Research that analyzed the strength of demand for that product. The complaint did not specify when this report was received by Tellabs, other than vaguely to assert that it was delivered "'in or about early 2001.'" Pet. App. 23a. According to respondents, however, the Probe Report led to a conclusion that 2001 revenue from the TITAN 5500 would decline by $400 million. Respondents also alleged that a confidential source reported that Tellabs had produced "internal reports" that "revealed by March 2001 that the market for the 5500 was drying up. *Id.* The complaint does not allege that Notebaert received or read either the Probe Research report or any of the unspecified, adverse internal reports, or was otherwise made aware of such reports, prior to having made any of his allegedly false statements.

Critical context as to these allegations was provided by publicly available documents that were referred to in the complaint and properly before the courts below. These documents made clear that on April 6, 2001, Tellabs began a public process of lowering its revenue projections precisely because, as it explicitly informed the market, it had observed a diminution in orders *during the latter portion of March 2001*. On April 6, Tellabs reduced its first quarter revenue guidance to $772 million (down from a range of $830 to $865 million). Tellabs specifically stated, in its analysts conference call held that same day, that it had experienced a fall-off in orders for the TITAN 5500 during the last two and half weeks of the first quarter (the end of March—which is consistent with the complaint's allegation that Tellabs produced internal reports in March 2001 indicating that demand for the product was weakening). Moreover, less than two weeks later, on April 18, 2006, Tellabs reduced its full year revenue projections to $3.6 to $3.7 billion, a nearly $800 million reduction from its original projections for 2001. Pet. App. 37a. This reduction is roughly double the $400 million reduction in revenue projections alleged to have been suggested by the internal report upon which respondents rely to establish Notebaert's scienter.

The reduction was accompanied by a clear statement that the business environment in which Tellabs was operating had changed within recent weeks. Tellabs explicitly advised that its customers were deferring, and in some cases reducing, capital spending. Pet. App. 36a-37a. Still, despite the reductions and concerns about the recent change in the business environment, Tellabs reported that sales in the first quarter of 2001, while not meeting its expectations for 30% growth, did grow by 21% over the prior year's first quarter, *id.* at 4a, which is consistent with Notebaert's alleged statement on April 6, 2001 that demand for the TITAN 5500 was continuing to grow. *Id.* at 23a. Respondents have never challenged the accuracy of those reported results for the first quarter of 2001. *Id.* at 64a.

3. Finally, respondents alleged certain false statements with respect to the TITAN 6500, which was then one of Tellabs' new products. Notebaert publicly stated, in March and April 2001, that customer demand for the 6500 was strong and that the company was shipping the product. As for the claim that Notebaert knew his statements in the spring of 2001 regarding the TITAN 6500 were false, the complaint relies exclusively upon a single confidential source who admittedly was no longer with the company by December 11, 2000, the start of the class period. Pet. App. 72a. The complaint contained no allegation that the confidential source had specific information about what Notebaert knew about the TITAN 6500 during the class period, or any reason to believe the confidential source would have had such specific information. Respondents also alleged, based upon the same source, that a Tellabs statement in December 2000 that the TITAN 6500 was "available now," made in connection with announcement of a $100 million multi-year sales agreement with Sprint for the TITAN 6500, was false.[2] The statement in question was not Notebaert's, however, *id.* at 84a, and no facts as to Notebaert's involvement were alleged.

4. The complaint alleges that the supposed fraud ended when Tellabs announced, on June 19, 2001 (only part-way through the second quarter), that orders for the TITAN 5500 had declined. Based on this reduction in demand, Tellabs revised its revenue projections for the second quarter by $300 million, and withdrew its full-year guidance.

Though Notebaert was allegedly engaged in a fraud to misstate Tellabs' fourth quarter 2000 financial performance

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[2] The putative confidential source claimed that in addition to defendants Jackman and Pullen, both of whom were alleged to be active in the development of the TITAN 6500, "Notebaert also knew about the TITAN 6500 problems." No facts were alleged regarding this assertion as to what Notebaert "knew." And this was the totality of the 6500 allegations pertaining directly to Notebaert. On appeal, respondents abandoned their § 10(b) claims against Jackman and Pullen.

and its 2001 financial projections, the complaint does not provide any reason *why* Notebaert or Tellabs would have suddenly started knowingly to misstate Tellabs' performance in December 2000 and, just as suddenly, stopped making false statements in June 2001—while also making several public downward revisions in projections in between. Notebaert is not alleged to have sold *any* shares of Tellabs stock during the period of alleged stock price inflation, or to have received any other personal benefit. Nor did the Second Amended Complaint allege that this supposed close-ended fraud had been undertaken in order to produce any benefit for the Company.

B. The District Court's Decisions.

The district court twice dismissed respondents' claims in lengthy, reasoned orders. Pet. App. 28-117a. As relevant here, in its second order, dismissing the entirety of respondents' Second Amended Complaint, the district court carefully examined the allegations of channel stuffing and false statements with respect to the TITAN 5500 and the TITAN 6500. The district court concluded that the allegations that respondents claimed pointed toward scienter were too vague to support a "strong inference" of scienter.

Specifically, with respect to the channel stuffing allegations (which form the basis of the claim that Notebaert participated in knowingly falsely inflating Tellabs' financial results for the fourth quarter of 2000), the district court noted that respondents had failed to "provide details" of precisely what "channel stuffing" activities Notebaert had engaged in. Pet. App. 74a. The district court noted that the absence of detail in the allegations was critical because the complaint had defined "channel stuffing" broadly enough to include innocent conduct. *Id.* at 58a, 74a, 99a-100a. These allegations were not enough, in the district court's view, to create a "strong inference" that Notebaert knowingly or recklessly engaged in improper channel stuffing activities.

The district court also examined the claim that the allegations regarding the Probe Research report, along with Tellabs' own internal reports, supported an inference that Notebaert acted with scienter in his statements about continued demand for the TITAN 5500. The district court first noted the conspicuous imprecision with respect to the alleged dates of the reports. Pet. App. 65a. The district court also noted that the complaint nowhere indicated "when Tellabs' revenue would feel the effect" of the allegedly predicted drop in demand. *Id.* The imprecision of the allegations was sufficient, according to the district court, to render the inference of scienter too weak to survive a motion to dismiss.

Finally, with respect to the remaining alleged false statements by Notebaert, the district court concluded that general allegations regarding "Notebaert's position in the company and general conclusions regarding his knowledge of the allegedly fraudulent activities without providing particulars" could not support a "strong inference" of scienter. Pet. App. 74a. Respondents' conclusory allegations regarding Notebaert's putative knowledge of problems with the TITAN 6500 were just that: allegations based on the non-specific assertion of a confidential source who had departed the company prior to the class period.

C. The Seventh Circuit's Decision.

1. Respondents appealed the dismissal of their § 10(b) claims against the company, Notebaert, and Tellabs' chairman of its Board, Michael Birck; the dismissal of the § 10(b) claims asserted against the remaining 4 of 6 individual defendants named in the complaint was not appealed. The Seventh Circuit affirmed the dismissal of the § 10(b) claims as to Birck, but reversed the dismissal as to Notebaert and the company.[3]

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[3] Respondents had also asserted control person liability claims under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a), against the various

As relevant here, the Seventh Circuit began with a discussion of the "strong inference of scienter" pleading standard. Pet. App. 17a-19a. Initially, the court rejected the position adopted by the Second and Third Circuits, discussed above, *supra* at 5, that courts should distinguish between different types of allegations for purposes of the "strong inference" analysis. Pet. App. 20a. The Seventh Circuit continued by identifying another disagreement among the courts of appeals regarding the "strong inference" standard: what it termed "the degree of imagination courts can use in divining whether a complaint creates a 'strong inference.'" *Id.* The court was referring to the possibility that allegations in a complaint might give rise to competing inferences with respect to a defendant's mental state, and that courts must decide whether and how much to credit possible innocent inferences against possible culpable inferences.

As the court noted, the Sixth Circuit has expressly held that a strong inference under the PSLRA must be "'the most plausible of competing inferences.'" Pet. App. 20a (quoting *Fidel* v. *Farley*, 392 F.3d 220, 227 (6th Cir. 2004)). The Seventh Circuit expressly rejected that view.

In so ruling, the court suggested that consideration of competing inferences "could potentially" infringe on a plaintiff's Seventh Amendment rights to have a jury draw reasonable inferences in its favor. Pet. App. 20a. Having raised the possibility of a Seventh Amendment issue attached to any weighing of inferences, the court, "while express[ing] no view" on the merits of that putative issue, proceeded to adopt a standard expressly designed to avoid the issue. Specifically, to avoid the possibility of "usurp[ing] the jury's

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individual defendants, and appealed the dismissal of those claims too as to Notebaert, Birck and two of the other individual defendants. In addition, respondents had asserted and appealed a claim for insider trading against Birck under 15 U.S.C. § 78t-1(a). The Seventh Circuit has allowed these additional claims to survive. Those claims are all derivative of the § 10(b) claims against Notebaert and the company, however.

role," the Seventh Circuit adopted a standard that "allow[s a] complaint to survive if it alleges facts *from which a reasonable person could* infer that the defendant acted with the required intent." *Id.* (emphasis added).

2. Consistent with its view that the strong inference standard requires a court to credit what a reasonable person "could" infer, the Seventh Circuit read the ambiguous allegations with respect to whether and when Notebaert became aware of weakness in demand for the TITAN 5500 in respondents' favor, without any consideration for the plausible inferences of an innocent mental state that could be drawn from the same facts. For example, the court noted that the complaint "somewhat vague[ly]" stated that the Probe Research report was created "'in or about early 2001.'" Pet. App. 23a. The court also noted the allegation that internal reports, created at an unspecified time in "March 2001," revealed that demand for the TITAN 5500 was declining.

These allegations, which the court relied upon heavily, were conspicuously ambiguous. First, the timing of the Probe Research report and alleged internal reports was left uncertain. The question of timing was critical, however, to Notebaert's alleged knowledge of the falsity of statements he made about the TITAN 5500, *e.g.*, in February and *early* March. And, this question of timing was particularly acute given that on April 6, 2001, Tellabs itself had publicly disclosed a drop-off in orders for the TITAN 5500 in the last weeks of March, and publicly reduced its first quarter guidance as a result—followed twelve days later by another reduction in its full-year estimates, producing a 2001 total projection that was $800 million less than originally forecast. Second, the court itself observed that it was "conceivable" that Notebaert had not seen the alleged reports at the time of his statements. In fact, the Second Amended Complaint (like prior versions) contained no allegation that he had. The court noted, however, the existence of an allegation that Notebaert had generally "stayed on top of the company's financial health." Pet. App. 23a.

The court nonetheless proceeded to reward respondents' ambiguous pleading as to Notebaert by crediting the inferences of scienter because they were within the realm of what a reasonable person might infer. Pet. App. 23a ("the plaintiffs have provided enough for a reasonable person to infer that Notebaert knew that his statements were false"). In doing so, the court made no mention and took no account of competing innocent inferences arising from, for example, the Company's voluntary, downwardly revised estimates made on April 6 and 18, and its accompanying disclosures of a weakening market.

Similarly, the court found that the complaint adequately alleged scienter with respect to the fourth quarter 2000 results because the complaint alleged that Notebaert knew about the "channel stuffing." Continuing to credit only a culpable inference if the alleged facts "could" support an inference of scienter, the court treated the "channel stuffing" allegation as if it alleged that "channel stuffing" meant *only* that "employees fabricated purchase orders for products that customers had not ordered." The court did not acknowledge what the District Court recognized, which is that the complaint defined "channel stuffing" to include innocent conduct, and failed to specify which type of conduct Notebaert had allegedly engaged in. Pet. App. 25a.

Finally, consistent with its refusal to consider potentially offsetting inferences, the Seventh Circuit did not consider or attempt to weigh the fact that the record revealed no apparent motive for Notebaert to engage in fraud during the class period, or any benefit either to him or the company. The Seventh Circuit simply closed its eyes to the innocent inferences that were readily available because its interpretation of the "strong inference" standard required that it not use its "imagination" to consider those innocent explanations at all.

REASONS FOR GRANTING THE PETITION

Congress passed the Reform Act in 1995 in response to a clear and abiding desire to bring an end to abusive strike suits involving meritless claims of securities fraud. S. Rep. No. 104-98, at 4, *reprinted in* 1995 U.S.C.C.A.N. at 683. Such claims were often "based on nothing more than a company's announcement of bad news, not evidence of fraud." *Id.* Defendants often quickly settled regardless of merit in order to avoid the expense and risk of litigation. *Id.* at 9, *reprinted in* 1995 U.S.C.C.A.N. at 688; see *Dura Pharmaceuticals, Inc.* v. *Broudo*, 544 U.S. 336, 347-48 (2005). The expense of such litigation was indirectly borne by the capital markets, imposing an additional cost on capital formation that hurt both investors and corporations. S. Rep. No. 104-98 at 4, *reprinted in* 1995 U.S.C.C.A.N. at 683.

Congress recognized that one source of the problem was that conflict among circuits on the legal standards for pleading securities fraud had created "opportunities for abuses." *Id.* In order to curb such abuses, Congress incorporated "uniform and more stringent pleading requirements" as a key feature of the Reform Act. H.R. Rep. No. 104-369, at 41, *reprinted in* 1995 U.S.C.C.A.N. at 740. One of the heightened pleading requirements is the critically important provision at issue here: a plaintiff must plead particularized facts giving rise to a "strong inference" that each defendant acted with the requisite mental state with regard to each alleged misrepresentation. 15 U.S.C. § 78u-4(b)(2). This constituted a marked departure from Fed. R. Civ. P. Rule 9(b), which otherwise allows state of mind allegations to be "averred generally." A complaint that fails to satisfy this heightened pleading burden cannot survive a motion to dismiss. 15 U.S.C. § 78u-4(b)(3)(a).

This case presents this Court with the opportunity to ensure that both of Congress's goals with respect to pleading of securities fraud complaints are satisfied. First, the legislative effort to provide uniformity has failed. The courts of appeals

have adopted meaningfully different interpretations of the "strong inference" standard, and of the role of competing inferences in judging whether any inference is "strong." Only this Court can establish a uniform standard. Second, the approach adopted by the Seventh Circuit in this case does serious violence to the deliberately high pleading standard adopted by Congress, and to its desire to provide businesses with relief from costly strike suits.

Both the different approaches among the federal courts of appeals and the Seventh Circuit's particularly lax standard for policing the scienter allegations in securities fraud complaints mark this case as an excellent vehicle for the Court to announce a uniform rule that meaningfully weeds out undeserving cases when the scienter allegations are insufficient. The federal securities fraud laws are frequently invoked in private litigation. According to the most recent statistics, there were 176 federal securities fraud class action claims filed in 2005 alone. Cornerstone Research, *Securities Class Action Case Filings: 2005: A Year in Review* 2 (2006), *available at* http://securities.stanford.edu/clearinghouse_research/2005_YIR/2006012302.pdf. Further, whether a complaint adequately alleges a "strong inference" of scienter is one of the most frequently litigated questions in such cases. Jonathan C. Dickey, *Current Trends in Federal Securities Litigation*, SL020 ALI-ABA 891, 906 (2005). The venue provisions of the securities laws provide for national service of process, 15 U.S.C. §§ 77v & 78aa, which gives the plaintiff in a securities fraud case flexibility with respect to the jurisdiction in which a claim can be filed. The potential for forum shopping in this commonly litigated area of the law exacerbates the inherent injustice of inconsistent application of federal law.

1. There is a 4-2-2-1 split of authority over the interpretation of the "strong inference" standard and the role of competing inferences. The courts of appeals have now presented four distinct approaches regarding whether, and to

what extent, courts should take into account inferences of a defendant's mental state that are innocent when determining whether the claimed inference of scienter is "strong." The different approaches reflect four very different ways of resolving a tension created by the "strong inference" standard.

In the ordinary case, a court ruling on a motion to dismiss draws all reasonable inferences in favor of the plaintiff. See *Leatherman* v. *Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 164 (1993). As various courts have observed, however, to credit only the inferences of a defendant's mental state that are in the plaintiff's favor—only the potentially culpable inferences—"would be to eviscerate the [Reform Act's] strong inference requirement by allowing plaintiffs to plead in a vacuum." *Gompper*, 298 F.3d at 896. If only the inferences in favor of plaintiffs are considered, according to these courts, then the "strong inference" requirement would amount to nothing more than a requirement that plaintiffs plead some facts that merely could reasonably point toward a culpable mental state, which would be contrary to the recognized view that Congress meant to raise the pleading bar for scienter. *E.g.*, *Helwig* 251 F.3d at 553 (strong inference requirement "represents a significant strengthening of the pre-PSLRA standard under Rule 12(b)(6), which gave the plaintiff the 'benefit of *all* reasonable inferences' and contemplated dismissal 'only if it is clear that no relief could be granted under *any* set of facts that could be proved consistent with the allegations'") (citations omitted).

Several courts have thus observed that "[i]n requiring a 'strong inference' of scienter, the PSLRA alters the normal operation of inferences under Fed. R. Civ. P. 12(b)(6)." *In re Digital Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 28 (1st Cir. 2002) (the Reform Act "alters the usual contours of a Rule 12(b)(6) ruling"); *Green Tree*, 270 F.3d at 660-61 (noting that "Congress has effectively mandated a special standard for

measuring whether allegations of scienter survive a motion to dismiss") (citing *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 195-96 (1st Cir. 1999)). Rather than merely crediting inferences favorable to the plaintiff's view, some courts acknowledge that they also should consider the inferences of an innocent mental state favorable to the defendant. *Credit Suisse*, 431 F.3d at 51 (in a securities fraud case, a court should not "turn a blind eye to the universe of possible conclusions stemming from a given fact or set of facts"); *Gompper*, 298 F.3d at 897 ("when determining whether plaintiffs have shown a strong inference of scienter, the court must consider *all* reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs"); *Pirraglia*, 339 F.3d at 1187 ("In evaluating the strength of a plaintiff's inference of scienter, we may recognize the possibility of negative inferences that may be drawn against the plaintiff.").

Still, among the courts that consider inferences favorable to the defendant, a dispute has emerged regarding how to incorporate those inferences into the analysis of whether the complaint adequately pleads facts establishing a "strong inference" of scienter. The First, Fourth, Sixth and Ninth Circuits have concluded that if the proposed inference of scienter is not the *most* plausible that may be drawn from the record, the inference of scienter is not "strong" within the meaning of the Reform Act. According to these courts, if an innocent inference is as plausible as a culpable inference, then the complaint should be dismissed. *Helwig*, 251 F.3d at 553 ("plaintiffs are entitled only to the most plausible of competing inferences"); *Gompper*, 298 F.3d at 896-97 (rejecting proposed inference of scienter where "it is equally if not more plausible" that defendants acted without fraudulent intent); *Credit Suisse*, 431 F.3d at 49 ("Scienter allegations do not pass the 'strong inference' test when, viewed in the light of the complaint as a whole, there are legitimate explanations for the behavior that are equally

convincing."); *Ottman*, 353 F.3d at 350 (rejecting inference of scienter because it "was just as likely" that the fact pattern alleged by plaintiffs was the result of an innocent "overgeneralization as it was the product of intentional deception or recklessness"). Under this standard, it is clear that the complaint in this case would be dismissed.

The Tenth and Eighth Circuits, however, do not require that an inference of scienter be more plausible than the inference of an innocent mental state in order to be characterized as sufficiently "strong." That decisional conflict by itself warrants this Court's review. The most thoroughly reasoned explanation for rejecting the "most plausible inference" approach has been provided by the Tenth Circuit in *Pirraglia*. There, the Tenth Circuit reasoned that weighing, in comparative fashion, the relative strength of competing inferences is not the province of a court ruling on a motion to dismiss. 339 F.3d at 1188. The Tenth Circuit expressly stated that if two inferences are "equally strong ..., one favoring the plaintiff and the other favoring the defendant," then the complaint should survive a motion to dismiss. *Id.* at 1187-88 (expressly rejecting the Sixth Circuit's standard in *Helwig*).

Rather than determine whether allegations give rise to a "strong inference" by evaluating which among competing inferences is the most plausible, the Tenth Circuit evaluates the strength of any scienter inference in light of "the context of other reasonable inferences that may be drawn." *Id.* at 1188. Ultimately, after considering all the facts and all the reasonable inferences drawn therefrom, the strength of any inference of scienter that emerges is subjected to a threshold standard. So long as that threshold of "strength" is met, the scienter pleading requirement is satisfied; it does not matter if the inference of scienter is the most plausible of the competing inferences. A "strong inference of scienter" in the Tenth Circuit is "a conclusion logically based upon particular facts that *would convince* a reasonable person that the

defendant knew a statement was false or misleading." *Adams* v. *Kinder-Morgan, Inc.*, 340 F.3d 1083, 1105 (10th Cir. 2003) (emphasis added). Moreover, in an attempt to reconcile the Reform Act with the traditional Rule 12(b)(6) standard that a complaint's factual allegations are to be viewed in the light most favorable to plaintiff, *Leatherman*, 507 U.S. at 164, the Tenth Circuit "will draw no inferences unfavorable to plaintiffs," but "will likewise refuse to draw inferences in the plaintiffs' favor" unless adequately supported in light of the "overall context." *Pirraglia*, 339 F.3d at 1187.

Like the Tenth Circuit, the Eighth Circuit has not adopted the "most plausible of competing inferences" standard of the Sixth Circuit. *In re K-tel Int'l, Inc. Sec. Litig.*, 300 F.3d 881, 889 n.6 (8th Cir. 2002). Instead, in *Green Tree* the Eighth Circuit, while not mentioning the Tenth Circuit by name, evaluated the complaint in a way that shows kinship with the Tenth Circuit's approach. The Eighth Circuit reversed the dismissal of a claim that company executives knowingly employed improper accounting practices to overstate the company's performance. The court recognized that the plaintiffs had alleged that the defendants possessed "knowledge of facts indicating crucial information in the statements was based on discredited assumptions." 270 F.3d at 665. It did not, however, stop there and hold that because a reasonable person might conclude that the defendants acted with scienter, the case must proceed. Rather, it confronted the defendants' alternative inferences pointing toward an innocent mental state. The defendants had argued that the accounting issues were complex for the sophisticated transactions at issue and that even "very large mistakes could fall within the realm of good faith." *Id.* at 666. The court recognized that "the defendants have many good arguments explaining how and why they thought their statements [were] proper." *Id.* at 667. Those arguments were not, however, strong enough to "sap[] the investors' allegations of their force at this procedural stage." *Id.*

The Seventh Circuit decision in this case provides a third approach. The Seventh Circuit, like the Tenth, expressly rejected the approach of four circuits that an inference of scienter is "strong" only if it is more plausible than any alternative inference. Pet. App. 20a. And, like the Tenth Circuit, the Seventh Circuit rejected such a comparative approach based on concerns about invading the province of the factfinder. *Id.* at 20a-21a (expressing concern that Sixth Circuit approach would violate the Seventh Amendment). But the Seventh Circuit went farther than any other court. Consistent with the Seventh Amendment concerns it voiced, the court created an especially liberal standard. A complaint should survive "if it alleges facts from which a reasonable person *could* infer that the defendant acted with the required intent." *Id.* at 20a (emphasis added). Conversely, only "[i]f a reasonable person could not draw such an inference from the alleged facts," is a defendant entitled to dismissal. *Id.* at 21a.

The Seventh Circuit's approach reflects the very approach specifically rejected by the Ninth Circuit in *Gompper*, 298 F.3d at 896. All that is necessary for a complaint to survive are facts from which it is merely reasonable to infer that the defendant acted with scienter. The Seventh Circuit nowhere qualified that analysis by recognizing or even discussing the importance of considering any inferences that the defendant acted with an innocent mental state. If a reasonable person "could" conceivably draw an inference of scienter, then the culpable inference is the only one a court should consider. The possibility that those same facts would support an innocent inference, or that other facts undermine the culpable inference, is legally irrelevant.

The limited nature of the Seventh Circuit's inquiry is confirmed by how it discussed the record in this case. Allegations that were said to support an inference of scienter were ambiguous enough, especially in the overall context of the record before the court, to support an inference of innocence. And, there were potential innocent inferences

arising from other facts before the court—*e.g.*, the April 6 and 18 downward guidance revisions and accompanying explanations—to which no consideration was afforded. The various other circuits discussed above would have wrestled with the innocent inferences, either to determine whether the inference of scienter was more plausible than the innocent inference (First, Fourth, Sixth and Ninth Circuits) or to determine whether the innocent possibility sufficiently weakened the inference of scienter to support dismissal (Eighth and Tenth Circuits). Further, the Tenth Circuit's threshold standard for an adequately "strong inference" is noticeably more exacting than that of the Seventh Circuit. The Tenth Circuit requires plaintiffs to plead "facts that *would convince* a reasonable person that the defendant knew a statement was false or misleading." *Adams*, 340 F.3d at 1105 (emphasis added). The Seventh Circuit has allowed a plaintiff to plead facts from which a reasonable person conceivably "*could*" draw an inference of scienter. Pet. App. 20a (emphasis added).

The Seventh Circuit's approach is substantially more lax than that taken by the Second and Third Circuits as well. As noted above, these courts divide scienter allegations into two types: motive and opportunity on the one hand, and strong circumstantial evidence of knowledge or recklessness on the other.[4] *Kalnit*, 264 F.3d at 138; *In re Advanta Corp.*, 180 F.3d at 534-35. How these courts apply the "strong

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[4] All the other courts of appeals to have considered the issue have held that the Reform Act requires courts to examine all the allegations in the complaint together, without drawing such distinctions. *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 196 (1st Cir. 1999); *Ottman*, 353 F.3d at 345; *Natheson* v. *Zonagen, Inc.*, 267 F.3d 400, 411-12 (5th Cir. 2001); *Hoffman* v. *Comshare (In re Comshare Sec. Litig.)*, 183 F.3d 542, 551 (6th Cir. 1999); Pet. App. 20a; *Green Tree*, 270 F.3d at 654-56; *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 985 (9th Cir. 1999); *City of Philadelphia* v. *Fleming Cos.*, 264 F.3d 1245, 1261-63 (10th Cir. 2001); *Bryant* v. *Avado Brands, Inc.*, 187 F.3d 1271, 1283 (11th Cir. 1999).

circumstantial evidence" standard is particularly relevant. Where there are no allegations of motive, these courts require that the strength of the circumstantial evidence of knowledge of falsity must be greater. *Kalnit*, 264 F.3d at 142; *GSC Partners CDO Fund* v. *Washington*, 368 F.3d 228, 238 (3d Cir. 2004). Here, by contrast, the Seventh Circuit made no attempt to factor in the negative inference arising from the absence of any claimed motive for Notebaert to commit fraud.

Moreover, while the Second and Third Circuits have yet to rule on what role innocent inferences should play in evaluating a securities fraud complaint for "strong circumstantial evidence" of knowledge of falsity, both have acknowledged the potential importance of the issue. *Press* v. *Quick & Reilly, Inc.*, 218 F.3d 121, 130 (2d Cir. 2000) (stating that whether fact pointing toward an innocent mental state could "negate allegations of fraudulent intent ... raises serious concerns"); *Rombach* v. *Chang*, 355 F.3d 164, 176 (2d Cir. 2004) (observing, *in dicta*, that a fact from which an innocent mental state may be inferred can "weaken[]" the strength of an inference of scienter); *Digital Island*, 357 F.3d at 328 (noting that "strong inference" standard "alters the normal operation of inferences" for a Rule 12(b)(6) motion). Both courts have largely avoided the issue for now because they categorically do not allow precisely the sort of ambiguous allegations presented here to suffice. These courts require that a plaintiff plead that a defendant had "knowledge of facts or access to information contradicting their public statements" at the time the public statements were made. *Novak* v. *Kasaks*, 216 F.3d 300, 308-09 (2d Cir. 2000); *GSC Partners*, 368 F.3d at 239-45. These courts apply this standard strictly by insisting upon particularized allegations that make clear that the relevant information was provided to the defendant. *Suez Equity Investors, L.P.* v. *Toronto-Dominion Bank*, 250 F.3d 87, 100 (2d Cir. 2001) (claim allowed to proceed against one insider defendant who had allegedly seen original report that had expressed concerns that

were omitted from later distributed modified report, but claim dismissed as to other insider defendants because no allegation that they had seen original report); *In re Alpharma Inc. Sec. Litig.*, 372 F.3d 137, 150-51 (3d Cir. 2004) (no strong inference of scienter as to insider defendants when there was no allegation that a whistleblower report of financial improprieties at the company's Brazilian subsidiary had been passed on to the defendants); *In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256, 278-79 (3d Cir. 2006) (strong inference of scienter alleged as to two insider defendants who allegedly excluded other employees from certain accounts with customers when those customers had pled guilty to creating false invoices and falsely labeling products at the direction of the company's management). The ambiguity in the timing of both the Probe Research report and the alleged internal reports, coupled with the admitted absence of any allegation that Notebaert saw any of these reports at the relevant time, would simply be fatal to the complaint in both the Second and Third Circuits.[5]

In the end, the contrast among the four different approaches is stark. The first two recognize the importance of considering plausible innocent inferences, but disagree regarding how to incorporate those inferences into determining whether any inference of scienter is "strong." The third, adopted by the Seventh Circuit in this case, eschews consideration of the innocent inferences and purports to protect the role of the factfinder by entertaining only the

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[5] The Second and Third Circuits also refuse to credit, as a substitute for particularized allegations of knowledge, the kind of generalized allegations accepted by the Seventh Circuit here, *i.e.*, that an executive "stayed on top of the Company's financial health," Pet. App. 23a. *Rombach*, 355 F.3d at 176 (allegation that defendants had "access to financial information and computer systems" is inadequate); *Advanta*, 180 F.3d at 539 (inadequate to allege that defendant "'must have known' a statement was false or misleading" because of his position in the company).

inferences favorable to the plaintiff. And to determine if those inferences should be credited, the Seventh Circuit asks only if a reasonable person "could" draw such inferences. The fourth approach has, for now, avoided determining how to incorporate innocent inferences by establishing a strict pleading standard, at odds with the Seventh Circuit's lax approach here, for claims that a defendant was aware of information contradicting his public statements at the time those public statements were made. This Court should grant the petition, reject the Seventh Circuit's approach, and provide an effective, clear, and uniform method for evaluating whether the inferences of scienter that may be drawn from a complaint are "strong" within the meaning of the Reform Act.

2. This case presents an excellent vehicle to review the "strong inference" standard. This case provides a strong record for this Court to consider and conclude whether and how to incorporate any inferences of an innocent mental state in the process of determining whether a securities fraud complaint alleges facts that create a "strong inference" that the defendant acted with scienter. The factual allegations at issue here are, at a minimum, subject to competing inferences (both innocent and culpable) in ways that arise frequently in securities litigation. For example, the complaint alleges the existence of internal reports discussing the declining demand for the TITAN 5500, but nowhere alleges that Notebaert actually reviewed any such report. Whether an executive of a corporation, by virtue of his position, "must have known" of internal reports commonly arises. See, *e.g.*, *Abrams* v. *Baker Hughes Inc.*, 292 F.3d 424, 432 (5th Cir. 2002); *Fleming*, 264 F.3d at 1263-64; *Advanta*, 180 F.3d at 539; *In re AOL-Time Warner Sec. & ERISA Litig.*, 381 F. Supp. 2d 192, 224, 230 (S.D.N.Y. 2004); *Smith* v. *Circuit City Stores, Inc.*, 286 F. Supp. 2d 707, 715 (E.D. Va. 2003); *D. E. & J Ltd. P'ship* v. *Conaway*, 284 F. Supp. 2d 719, 743 (E.D. Mich. 2003), *aff'd*, 133 F. App'x 994 (6th Cir. 2005); *In re Acterna Corp. Sec. Litig.*, 378 F. Supp. 2d 561, 573-75 (D. Md. 2005); *In re Cree, Inc. Sec. Litig.*, 333 F. Supp. 2d 461, 475 (M.D.N.C.

2004); *Lirette* v. *Shiva Corp.*, 27 F. Supp. 2d 268, 283 (D. Mass. 1998) (citing *Maldonado* v. *Dominquez*, 137 F.3d 1, 9 (1st Cir. 1998)).

Also, the particularly lax approach to pleading scienter adopted by the Seventh Circuit here provides an especially urgent reason for this Court's review. Not only do meaningful differences in the interpretation of the statute prevail, but the Seventh Circuit has adopted a standard that encourages plaintiffs to employ strategic ambiguity in their pleadings to survive a motion to dismiss and accomplish precisely what the Reform Act was supposed to end: the imposition of massive litigation costs on businesses based on little more than a downturn in share price.

Respondents' claim depends on such strategic ambiguity. For example, it is utterly unclear when Notebaert is alleged to have learned from the Probe Research report and internal reports—reports he is not even alleged to have seen—that demand for the TITAN 5500 was softening. The dates on which the reports were created and when Notebaert might have reviewed them are critical to establishing his scienter. Yet the complaint alleges only that the Probe Research Report was created "'in or about early 2001'" and that the internal report was created in March 2001. Pet. App. 23a. These alleged dates cover the period all the way through the end of March 2001, which is significant in light of the fact that on April 6, 2001, Tellabs began lowering revenue projections precisely because, as it expressly disclosed to the market on that day, there was an unanticipated fall-off in orders for the TITAN 5500 during the last two and a half weeks of March. And on April 18, 2001, Tellabs lowered its own revenue projection for all of 2001 to an amount that was $800 million less than originally forecast, an amount *greater* than that allegedly suggested by the Probe Research report. *Id.* at 23a, 37a. Put simply, these facts make it clear that an inference of an innocent mental state is perfectly consistent with the allegedly broad of range of time in which the reports were issued. The Seventh Circuit has rewarded this ambiguity by

giving respondents the advantage of the most favorable inference that might be drawn from it.

The same is true with respect to the allegations of "channel stuffing." The First Amended Complaint defined both legitimate and illegitimate conduct as "channel stuffing." Despite the opportunity to replead, after the district court identified this critical ambiguity in its first dismissal order, respondents neither narrowed their definition of "channel stuffing" nor ever specified which "channel stuffing" activities Notebaert allegedly knew about or participated in. They left the allegations as to his knowledge of "channel stuffing" ambiguous enough to mean knowledge of either legitimate or illegitimate conduct. Once again, the Seventh Circuit rewarded the ambiguity by crediting the inference most favorable to respondents. Pet. App. 25a.[6]

Any approach to the Reform Act that rewards strategic ambiguity in pleading should be rejected. The fact that the statute requires the pleading of particularized facts that give rise to "a 'strong,' rather than merely a 'reasonable,' inference that the defendant acted with scienter is more than an odd linguistic quirk." *Credit Suisse*, 431 F.3d at 48. Congress's intent in including the "strong inference" requirement was to raise the standard for pleading scienter in

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[6] The Seventh Circuit's lax application of the "strong inference" standard is further illustrated by how it concluded that the § 10(b) claim against the other individual defendant on appeal, Birck, should be dismissed. Birck had sold a small amount of stock during the class period, but the court concluded the sale was insufficient to establish any motive. In addition, Birck's last statement regarding the TITAN 5500 was in February 2001. But, as the court noted, the complaint's allegations supported an inference that the earliest date that "the TITAN 5500's declining status was obvious" to Tellabs executives was sometime in March 2001, Pet. App. 24a. Even though there was no motive, and even though there was no pleaded basis to infer that Birck had been aware of contrary information at the time of his last public statement, the court nonetheless deemed the question whether there was a "strong inference" of his scienter to be a "close" one. *Id.*

securities fraud actions to limit the types of cases that would be allowed to survive a motion to dismiss and go forward to discovery. *E.g.*, *Comshare*, 183 F.3d at 548 ("In 1995, Congress concluded that Rule 9(b) had not prevented abuse of the securities laws by private litigants.'") (quoting H.R. Rep. No. 104-369, at 41, *reprinted in* 1995 U.S.C.C.A.N. at 740)). The Seventh Circuit's decision to credit only the reasonable inferences that favor respondents' view effectively revives the traditional standard of pleading under Rule 8(a), under which a plaintiff is entitled to have all reasonable inferences drawn in its favor. See, *e.g.*, *Swierkiewicz* v. *Sorema N.A.*, 534 U.S. 506, 514 (2002). The Reform Act was supposed to put an end to precisely what the Seventh Circuit has allowed.

It was the Seventh Circuit's concern for avoiding supposed Seventh Amendment issues that led it to eschew competing negative inferences, and to focus only on whether reasonable inferences favorable to the plaintiff existed. Pet. App. 20a. That concern was misplaced. Congress's power to impose heightened pleading requirements, whether in a statute or in the Federal Rules of Civil Procedure, has never been questioned. *E.g.*, *Swierkiewicz*, 534 U.S. at 512-13; *Leatherman*, 507 U.S. at 168. Whether a complaint meets these requirements is a procedural matter, and a question of law, properly left to the courts. The jury trial right is simply not implicated at the motion to dismiss stage because "the issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims." *Scheuer* v. *Rhodes*, 416 U.S. 232, 236 (1974), *overruled on other grounds*, *Harlow* v. *Fitzgerald*, 457 U.S. 800 (1982); see also *Baltimore & Carolina Line, Inc.* v. *Redman*, 295 U.S. 654, 657 (1935) (noting that the Seventh Amendment is not implicated where matters of procedure and issues of law are concerned). The "strong inference" standard reflects Congress's policy judgment that plaintiffs should be entitled to impose burdens on the defendants and the courts only if the plaintiffs already have acquired enough facts to

create a strong inference of scienter. And other courts that have similarly considered the Seventh Amendment have not understood the Constitution to bar them from giving due consideration to the inferences that may be drawn in favor of the defendant. *City of Monroe Employees Ret. Sys.* v. *Bridgestone Corp.*, 399 F.3d 651, 683 n.25 (6th Cir. 2005), *cert. denied sub nom.* 126 S. Ct. 423 (2005); *Pirraglia*, 339 F.3d at 1188.

In the end, the courts are deeply divided regarding how to give effect to the "strong inference" protections for securities fraud defendants that Congress adopted in the Reform Act. The Seventh Circuit has uniquely weakened those protections without warrant. This Court should accept review to ensure both the uniform and effective application of "strong inference" standard.

CONCLUSION

This petition for writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
SEVENTH CIRCUIT

No. 04-1687

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
Plaintiffs-Appellants,

v.

TELLABS, INC., *et al.*,
Defendants-Appellees.

Argued Jan. 21, 2005
Decided Jan. 25, 2006
Rehearing en Banc Denied July 10, 2006
As Modified on Denial of Rehearing July 10, 2006

Before RIPPLE, WOOD, and SYKES, *Circuit Judges*.

WOOD, *Circuit Judge*.

This class action against Tellabs, Inc., a manufacturer of specialized equipment used in fiber optic cable networks, presents the first opportunity for this court to address the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995 (PSLRA), 15 U.S.C. § 78u-4(b). The plaintiffs have accused Tellabs and its executives of engaging in a scheme to deceive the investing public about the true value of Tellabs's stock. The district court dismissed the plaintiffs' second amended complaint, pursuant to Federal Rule of Civil Procedure 12(b)(6), after finding that the plaintiffs had failed to meet the PSLRA's pleading threshold. We affirm in part and reverse in part.

I

With the aid of 27 confidential sources, the plaintiffs, a putative class of Tellabs stockholders, allege that Tellabs's fraudulent conduct began on December 11, 2000. (We assume the truth of the well-pleaded allegations in the complaint, as we must upon review of a Rule 12(b)(6) dismissal.) See, *e.g., Harrell v. Cook,* 169 F.3d 428, 431 (7th Cir.1999). On that day, Tellabs issued a press release stating that Tellabs and Sprint had signed a multi-year, $100 million contract for one of Tellabs's next-generation products, the TITAN 6500. The release proclaimed that "[t]he TITAN 6500 system is available now." In a call to financial analysts later that day, Tellabs's Chief Executive Officer (CEO), Richard Notebaert, predicted that in addition to the contract with Sprint for the 6500, there would be "continuing growth of the TITAN 5500," referring to the 6500's predecessor. Based in part on these representations, most market analysts recommended that investors buy Tellabs's stock.

On January 23, 2001, in a press release announcing Tellabs's "record sales and earnings in the fourth quarter of 2000," Notebaert proclaimed that "customers are buying more and more Tellabs equipment." In an accompanying call to analysts, Notebaert stated that Tellabs had "set the stage for sustained growth with the successful launches of several products." Later, in response to a question, Notebaert stated, "On the 6500, demand for that product is exceeding our expectations." In another interview that day, Notebaert said, "we feel very, very good about the robust growth we're experiencing."

Continuing with these sunny assessments, on February 14, 2001, Tellabs sent a letter to stockholders, signed by Notebaert and Richard Birck, Tellabs's chairman and former CEO, that stated: "Tellabs'[s] growth is robust. . . . Our markets hold significant potential for sustained growth. . . . Our core business is performing well. . . . [S]ales of our

TITAN 5500 digital cross-connect systems soared 56% in 2000. . . . The new TITAN 6500 multiservice transport switch emerged from our laboratories in 2000, and customers are embracing it." In the annual report that accompanied this letter, Birck and Notebaert responded as follows to investors' frequently asked questions:

> Q. Your core business is built on the TITAN 5500—are you worried that this product has peaked?
>
> A. No. In 2000, TITAN 5500 revenues grew 56%, its best year so far. Although we introduced this product nearly 10 years ago, it's still going strong. . . .

The first public glimmer that business was not quite so healthy came in March 2001. At that time, Tellabs modestly reduced its first quarter sales projections from a range of $865 million to $890 million to a range of $830 million to $865 million. This revision was attributable to lower-than-expected growth in Tellabs's CABLESPAN® business, a product unrelated to this action. As Tellabs announced this reduction, it reiterated its positive forecasts for its other products. In a conference call with analysts, Notebaert stated:

> [D]emand for our core optical products, or our core networking products remains strong. . . . Interest in and demand for the 6500 continues to grow. . . . We continue to ship the 6100 and 6500 through the first quarter. We are satisfying very strong demand and growing customer demand. We are as confident as ever—that may be an understatement—about the 6500. . . . Tellabs will meet the adjusted revenue and earnings targets.

Notebaert maintained this upbeat tone while discussing the TITAN 5500. In response to an investor's question whether Tellabs was experiencing "any weakness [ ] at all" in demand for the 5500, Notebaert responded, "No, we're not. We're still seeing that product continue to maintain its growth rate." Tellabs's 10-K statement for the fiscal year ended December

29, 2000, filed three months later on March 29, 2001, maintained this rosy outlook.

Nevertheless, on April 6, 2001, Tellabs reduced its first quarter sales projections once again—down to $772 million from the $830 to $865 million range it had forecast just a month earlier. Notebaert cautioned that Tellabs's customers were deploying their new equipment slowly and "exercising a high degree of prudence over every dollar spent." In the face of this downward revision, Notebaert informed investors that "everything we hear from the customers indicates that . . . demand for services continues to grow." Notebaert insisted that the demand for the TITAN 6500 was "very strong" and explained that the only reason for the downward projections was that Tellabs's customers were pushing orders back from the first to the second quarter of 2001.

Less than two weeks later, Tellabs announced that sales for the first quarter were in fact $772 million. While significantly below the original projections, this still represented a 21% increase in sales over the first quarter of 2000. Nonetheless, Tellabs announced that it was abandoning one of the products it had been touting, the SALIX program, just 14 months after purchasing it for $300 million.

Despite the mixed news, analysts still thought that Tellabs was a stock worth buying. By this point, though, the company's stock price had fallen from a high of $67 per share to somewhere in the low $30 range. Over the next few months, while Tellabs's executives kept mum, the company's stock crept back up to over $38. Then, on June 19, 2001, the last day of the class period, Tellabs announced a substantial reduction in its second quarter projections. It had projected that sales would be between $780 and $820 million, but it now revealed that its second quarter revenues would amount to only $500 million. On yet another conference call, Notebaert informed investors that the reduction was almost entirely because of an enormous reduction in TITAN 5500

sales. The next day, Tellabs's stock price plunged to $15.87 per share.

On December 3, 2002, the plaintiffs filed their first complaint against Tellabs and 10 of its executives. The complaint alleged that Tellabs's executives knowingly lied to the public, in the following particular ways: (1) they had informed the market that the TITAN 6500 was available when in fact it was not; (2) they had represented that demand for the TITAN 5500 was stable or even growing when in fact they knew that it was waning; (3) they said that the SALIX line of products was bound for success when in fact Tellabs knew that it was bound to fail; (4) they portrayed Tellabs's fourth quarter revenues and earnings for 2000 as stellar when in fact they were fraudulently inflated; and (5) they announced that Tellabs's future earnings would be greater than actually expected.

The defendants moved to dismiss the complaint for failure to state a claim. The district court granted the motion, with leave to amend, finding that (1) all but one of Tellabs's projections were accompanied by meaningful cautionary language, and thus fell within the scope of the "safe harbor" provisions of the PSLRA; (2) the plaintiffs had failed to offer particularized facts to support their claim that Tellabs misrepresented its fourth quarter 2000 results; and (3) the complaint failed adequately to allege that the defendants met the scienter standard for securities fraud, which requires that they likely intended "to deceive, manipulate, or defraud." See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 & n. 12, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976).

On July 3, 2003, the plaintiffs filed a second amended complaint, bolstering their allegations with references to 27 confidential sources, shortening the list of defendants by four, eliminating a few of their weaker claims, and adding more specific scienter allegations against each of the remaining defendants. While the district court found that a number of

the statements are actionable, it nonetheless dismissed again because, it thought, the plaintiffs still had failed adequately to allege scienter for any of the defendants. The court echoed its earlier holding that the PSLRA safe harbor provision protected Tellabs's forecasts. The plaintiffs appeal, arguing that (1) some of the statements the court dismissed as "mere puffery" are legally actionable; (2) their complaint provided enough detail to support a strong inference of scienter for each of the defendants; and (3) the disclaimer accompanying Tellabs's forecasts was insufficient and therefore Tellabs could not rely on the PSLRA's safe harbor provision.

II

The plaintiffs' complaint alleges three distinct statutory violations. First, the plaintiffs contend that Tellabs, as a company, and Birck and Notebaert, as individuals, violated § 10(b) of the Securities Exchange Act of 1934, codified in 15 U.S.C. § 78j, and Securities Exchange Commission (SEC) Rule 10b-5, 17 C.F.R. § 240.10b-5. Second, the complaint alleges that Notebaert, Birck, and two other Tellabs executives were "control persons" and therefore liable under § 20(a) of the Securities Exchange Act, 15 U.S.C. § 78(t), for the corporation's fraudulent acts. Finally, the plaintiffs allege that Birck engaged in illegal insider trading in violation of § 20A of the Act, 15 U.S.C. § 78t-1. The control person and insider-trading allegations require an underlying securities fraud violation. Because the district court rejected the plaintiffs' underlying securities fraud complaint, it also dismissed these attendant claims. We as always review the district court's decision to dismiss under Rule 12(b)(6) *de novo*, see *In re: Cerner Corp. Sec. Litig.*, 425 F.3d 1079, 1083 (8th Cir.2005), as well as its interpretation of the heightened pleading requirements of the PSLRA.

Unlike a run-of-the-mill complaint, which will survive a motion to dismiss for failure to state a claim so long as it is "possible to hypothesize a set of facts, consistent with the

complaint, that would entitle the plaintiff to relief," *Sanville v. McCaughtry*, 266 F.3d 724, 732 (7th Cir.2001) (quotation omitted), the PSLRA essentially returns the class of cases it covers to a very specific version of fact pleading—one that exceeds even the particularity requirement of Federal Rule of Civil Procedure 9(b). See, *e.g., In re: Rockefeller Center Props., Inc. Sec. Litig.*, 311 F.3d 198, 217 (3d Cir.2002) (noting that the PSLRA "imposes another layer of factual particularity to allegations of securities fraud"). Under the PSLRA, a securities fraud complaint must (1) "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed" and (2) "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(1), (2). In other words, plaintiffs must not only plead a violation with particularity; they must also marshal sufficient facts to convince a court at the outset that the defendants likely intended "to deceive, manipulate, or defraud." *Ernst & Ernst*, 425 U.S. at 194 & n. 12, 96 S.Ct. 1375. Most of the debate within the courts of appeals has concerned the second requirement: how much, in the way of factual detail in the pleadings, is sufficient to create this "strong inference" of the requisite scienter? Before we address that question, however, it is helpful to review Tellabs's actionable statements and the district court's assessment of them.

A

Passed in the 1930s in reaction to the stock market crash of 1929 and the Great Depression, the modern securities laws were designed, according to the Supreme Court, to "substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics

in the securities industry." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963). "'There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy.'" *Basic Inc. v. Levinson*, 485 U.S. 224, 230, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988) (quoting H.R.Rep. No. 1383, 73d Cong., 2d Sess., 11 (1934)). Under § 10(b) of the Securities Exchange Act and Rule 10b-5, a plaintiff can obtain damages if she can prove (1) the defendant made a false statement or omission (2) of material fact (3) with scienter (4) in connection with the purchase or sale of securities (5) upon which the plaintiff justifiably relied and (6) that the false statement proximately caused the plaintiff damages. See, *e.g., Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 648 (7th Cir.1997).

The first pleading hurdle of the PSLRA requires the plaintiff to support with particularity the first two elements noted above: the falsity of the statement of fact or the omission, and its materiality. It is not enough simply to allege in general that the defendant's statement was false and material. Looking first at the "falsity" requirement, we see that the PSLRA requires the complaint to specify each statement that is allegedly misleading, the reasons why it is so, and, if based on information and belief, what specific facts support that information and belief. See 15 U.S.C. § 78u-4(b)(1). Although § 78u-4(b)(1) requires a complaint to state "*all* facts on which that belief is formed," this does not mean that a complaint automatically survives if it lists "all" of the facts supporting the plaintiff's belief. Nor does it mean that if the plaintiff alleges sufficient facts but leaves out a redundant detail, the court must dismiss the complaint. As the Second Circuit has held, such exactitude would render the statute meaningless:

> Reading "all" literally would produce illogical results that Congress cannot have intended. Contrary to the clearly expressed purpose of the PSLRA, it would allow

> complaints to survive dismissal where "all" the facts supporting the plaintiff's information and belief were pled, but those facts were patently insufficient to support that belief. Equally peculiarly, it would require dismissal where the complaint pled facts fully sufficient to support a convincing inference if any known facts were omitted.

Novak v. Kasaks, 216 F.3d 300, 314 n. 1 (2d Cir.2000). We agree with the Second Circuit that the relevant question is "whether the facts alleged are sufficient to support a reasonable belief as to the misleading nature of the statement or omission." *Id.*

Often, as is the case here, plaintiffs rely at the pleading stage on confidential sources to meet this requirement, creating yet another knotty complication. Does the identity of the plaintiffs' sources necessarily fall within the facts required to support a reasonable belief that the defendant has committed fraud? Other circuit courts have said that it does not. *California Pub. Employees' Ret. Sys. v. Chubb Corp.*, 394 F.3d 126, 146 (3d Cir.2004); *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 351-54 (5th Cir.2002); *In re: Cabletron Systems, Inc.*, 311 F.3d 11, 29-31 (1st Cir.2002); *Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 667-68 (8th Cir.2001); *Novak*, 216 F.3d at 314. We agree with our colleagues that it would be too much to require plaintiffs to provide "name, rank, and serial number" for each of these sources. They must, however, describe their sources with sufficient particularity "to support the probability that a person in the position occupied by the source would possess the information alleged," *Novak*, 216 F.3d at 314, or in the alternative provide other evidence to support their allegations. This standard protects the privacy of the sources while still ensuring that the court has enough information to assess the soundness of the plaintiffs' allegations. A bright line rule obliging the plaintiffs to reveal their sources

has the potential to deter informants from exposing malfeasance. Such a rule might also invite retaliation. Nonetheless, plaintiffs must still provide significant detail about their informants. If the descriptions indicate that the sources would not have access to, or knowledge of, the facts underlying the allegations, the allegations would be insufficient.

Turning to the materiality requirement, we note initially that materiality depends upon the facts. It is necessary to examine "the significance the reasonable investor would place on the withheld or misrepresented information." *Basic*, 485 U.S. at 240, 108 S.Ct. 978. As the Fourth Circuit has clarified, there must be "a substantial likelihood that a reasonable purchaser or seller of a security (1) would consider the fact important in deciding whether to buy or sell the security or (2) would have viewed the total mix of information made available to be significantly altered by disclosure of the fact." *Longman v. Food Lion, Inc.*, 197 F.3d 675, 682-83 (4th Cir.1999); see also *Searls v. Glasser*, 64 F.3d 1061, 1066 (7th Cir.1995) (finding that materiality exists when "there is a substantial likelihood that disclosure of the information would have been viewed by the reasonable investor to have significantly altered the total mix of information"). The crux of materiality is whether, in context, an investor would reasonably rely on the defendant's statement as one reflecting a consequential fact about the company. If the statement amounts to vague aspiration or unspecific puffery, it is not material. See *Eisenstadt v. Centel Corp.*, 113 F.3d 738, 746 (7th Cir.1997) ("Mere sales puffery is not actionable under Rule 10b-5.").

With these principles in mind, we turn to the plaintiffs' allegations against Notebaert and Birck. The plaintiffs' allegations fall into four categories: (1) statements overstating the demand for the TITAN 5500; (2) statements concerning the availability of the TITAN 6500; (3) statements regarding Tellabs's financials for the fourth quarter of 2000; and (4) statements exaggerating Tellabs's earnings and revenue pro-

jections. We begin with the question whether the complaint adequately alleged that the statements were misleading. It identifies 27 confidential sources, noting the position each held within Tellabs and the dates of each person's employment with the company. *Cf. Chubb Corp.*, 394 F.3d at 148 (finding problematic the complaint's failure to detail when the plaintiffs' confidential sources worked for the defendant). The list includes former managers and high-level executives. The descriptions provided in the complaint reveal that many of the informants were in a position to provide reliable information concerning whether Birck's and Notebaert's statements were false and material and whether Birck and Notebaert knew this to be the case.

By January 2001, the complaint asserts, demand for Tellabs's "best seller"—the TITAN 5500—was drying up. Verizon, Tellabs's largest customer, reduced its orders for the TITAN 5500 by roughly 25% in late 2000 and by roughly 50% in January 2001. Customers in Latin America and Central America were no longer buying the product. By late 2000, according to a couple of the confidential sources, Tellabs had excess TITAN 5500s on hand because of the lack of demand. One confidential source informed the plaintiffs that Tellabs paid Probe Research, an outside company, $100,000 to forecast demand for the TITAN 5500. Completed "in or about early 2001," the report showed that the market need for the TITAN 5500 was evaporating. Based on this research, Tellabs's marketing strategy department distributed an internal memorandum that concluded that revenue from the TITAN 5500 would decline by about $400 million.

Even taking into account this declining demand, we agree with the district court that some of the statements attributed to Notebaert during this time amount to no more than puffery. It is doubtful that an investor would rely on statements like "we feel very, very good about the robust growth we're experiencing," or "demand for our core optical products . . . remains

strong." These vague comments did not identify the TITAN 5500 in particular and were unlikely to induce an investor to purchase Tellabs's stock.

Other statements are more troublesome, especially when viewed against the backdrop of the company's upbeat attitude. On March 8, 2001, in response to a question from a Deutsche Bank analyst about whether Tellabs was experiencing any weakness in TITAN 5500 sales, Notebaert responded: "We're still seeing that product continue to *maintain its growth rate*; it's still experiencing strong acceptance." (Emphasis added.) In context, this went well beyond puffery: it was a direct response to an analyst's inquiry about a possible decline in TITAN 5500 sales. It is reasonable that an analyst or investor would take Notebaert at his word, and it is misleading to describe a decline as equivalent to a continued growth rate.

Similarly, in Tellabs's 2000 Annual Report, published in February 2001, Notebaert and Birck responded to a frequently asked question ("[A]re you worried that [the TITAN 5500] has peaked?") by stating flatly, "No. . . . Although we introduced the product nearly 10 years ago, it's still going strong." Perhaps in a different context this statement would amount to puffery, but its place in the "frequently asked questions" section of the Annual Report suggests that the answer was particularly important to investors. It would be reasonable for an investor to rely on the statement, believing that sales for the TITAN 5500 were "still going strong."

As with the statements pertaining to the TITAN 5500, some of the statements concerning the TITAN 6500 are not the type on which an investor would reasonably rely. Notebaert's statement, for example, that "[o]n the 6500, demand for that product is exceeding our expectations" essentially is meaningless. As one court has put it, "[i]t is hard to imagine a more subjective or vague statement than 'exceeded our expectations.' This is precisely the type of

statement that the marketplace views as pure hype, and accordingly discounts entirely." *In re Allaire Corp. Sec. Litig.*, 224 F.Supp.2d 319, 331 (D.Mass.2002).

As the district court found, however, some of Tellabs's statements regarding the TITAN 6500 crossed into the realm of material falsity. According to the complaint, the TITAN 6500 was not available for delivery until well after the class period ended. Yet on December 11, 2000, the first day of the class period, Tellabs flatly stated, "The TITAN 6500 system is available now." On March 8, 2001, Notebaert told analysts, "Interest in and demand for the 6500 continues to grow. . . . We continue to ship the . . . 6500 through the first quarter. We are satisfying very strong demand and growing customer demand." Again, on April 6, 2001, in response to an analyst's question whether Tellabs was still on track to recognize TITAN 6500 revenue in the second quarter, Notebaert stated, "we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong." These statements are particular, specific, and, according to the complaint, completely false. The plaintiffs have alleged with sufficient particularity that some of Notebaert's statements regarding the TITAN 6500 were material and false.

The plaintiffs further allege that the defendants falsely represented Tellabs's financial results for the fourth quarter of 2000. Although the amended complaint alleges that Tellabs inflated its fourth quarter numbers through the use of fictitious sales, back-dated orders, and "creative" incentives, the only allegation that the plaintiffs pleaded with sufficient particularity is the charge that Tellabs flooded its downstream customers with unordered TITAN 5500s. This practice, known as channel stuffing, creates a short-term illusion of increased demand between the time when the company sends the extra product down the line and the time when the

distributors return the unwanted excess. According to the plaintiffs' confidential sources, Tellabs had to lease extra storage space in January and February 2001 to accommodate the large number of returns.

While there may be legitimate reasons for attempting to achieve sales earlier via channel stuffing, providing excess supply to distributors in order to create a misleading impression in the market of the company's financial health is not one of them. The complaint relies on several confidential sources to support the channel stuffing allegation. For example, one source informed class counsel that Verizon's chairman had asked Tellabs to stop providing Verizon, Tellabs's largest customer, with products that Verizon did not request or require. Given the consistency and specificity of the plaintiffs' channel stuffing allegations, the district court found, and we agree, that the amended complaint provided sufficient detail of channel stuffing to overcome the PSLRA's material falsity hurdle.

Finally, the plaintiffs identify a series of what turned out to be overstated revenue projections made by Tellabs, which, according to the complaint, were meant to induce investors to purchase Tellabs stock. The district court found that because Tellabs included disclaimers along with each of these projections, the statements fell within the PSLRA's safe harbor provision. "The statutory safe harbor forecloses liability if a forward-looking statement 'is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.'" *Asher v. Baxter Intern. Inc.*, 377 F.3d 727, 729 (7th Cir.2004) (quoting 15 U.S.C. § 77z-2(c)(1)(A)(i)). Here, Tellabs accompanied each projection with the following statement:

> Actual results may differ from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to,

> risks associated with introducing new products, entering new markets, availability of resources, competitive response, and a downturn in the telecommunications industry. The company undertakes no obligation to revise or update these forward-looking statements to reflect events or circumstances after today or to reflect the occurrence of unanticipated events.

After the district court's decision, this court decided *Asher*, 377 F.3d 727, which confronted the issue of what constitutes a "meaningful cautionary statement." In *Asher*, the defendant listed a host of consequential variables in its safe harbor disclaimer similar to those mentioned by Tellabs. The *Asher* plaintiffs argued that the defendant's disclaimer was mere boilerplate, while the defendant, Baxter International, argued that it need not provide greater detail, as the disclaimer mentioned each of its business segments. *Id.* at 732-33. We rejected both extremes:

> Plaintiffs say that Baxter's cautions were boilerplate, but they aren't. Statements along the lines of "all businesses are risky" or "the future lies ahead" come to nothing other than caveat emptor (which isn't enough); these statements, by contrast, at least included Baxter-specific information and highlighted some parts of the business that might cause problems. For its part, Baxter says that mentioning these business segments demonstrates that the caution is sufficient; but this also is wrong, because then any issuer could list its lines of business, say "we could have problems in any of these," and avoid liability for statements implying that no such problems were on the horizon even if a precipice was in sight.

Id. at 733. We concluded that a disclaimer falls within the safe harbor provision only if it mentions "those sources of variance that (at the time of the projection) were the principal or important risks." *Id.* at 734. Since we could not assess this

question on the pleadings and record then available to us, we remanded the case to district court.

According to the complaint, the defendants knew at the time they made the projections that demand for the TITAN 5500 was drying up and that production of the TITAN 6500 was far behind schedule. Tellabs argues that the disclaimer covered these contingencies by warning investors that a "downturn in the telecommunications industry" could affect its forecasts and that there are "risks associated with introducing new products." Without doubt, these generalized statements encompass Tellabs's troubles with the TITAN 5500 and 6500; they also encompass a whole world of other possible contingencies. The breadth of these warnings makes it impossible for us to conclude that they meaningfully described "the principal or important risks" facing Tellabs at the time it made the projections. Indeed, this level of generality exemplifies the useless *caveat emptor* boilerplate we criticized in *Asher*. See *id.* at 733. Accordingly, we find that Tellabs's warnings were not particularized enough for it to claim shelter under the PSLRA's safe harbor provision.

In sum, we agree with the district court that some of the defendants' statements regarding the TITAN 5500 and 6500 amounted to nothing more than immaterial puffery. The defendants do not contest the district court's finding that other statements made in connection with these products and the company's past results are actionable. We too conclude that this is the case. Finally, we disagree with the district court's conclusion that Tellabs was entitled to take advantage of the safe harbor; to the contrary, we find that it did not accompany its financial projections with a "meaningful cautionary statement."

B

All of this will not affect the ultimate outcome of this case, however, unless the plaintiffs can clear another, even more

arduous, hurdle: adequately alleging scienter. In passing the PSLRA, some in Congress recorded their belief that Federal Rule of Civil Procedure 9(b) had "not prevented abuse of the securities laws by private litigants." H.R. Conf. Rep. No. 104-369, at 41 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 740. To address this perceived abuse, the PSLRA changes the threshold pleading rules by requiring that the complaint "with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

According to the Ninth Circuit, in enacting § 78u-4(b)(2), Congress also raised the substantive state of mind requirement for securities fraud allegations. See *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 979 (9th Cir.1999) (determining that a plaintiff must allege facts that create a strong inference of "deliberate or conscious recklessness" or a "degree of recklessness that strongly suggests actual intent"). We are not persuaded by this position. Prior to the passage of the PSLRA, every circuit to consider the substantive scienter standard—including the Ninth—had held that a showing of recklessness was sufficient to allege scienter. See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569-70 (9th Cir.1990); *In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1244 (3d Cir.1989); *Van Dyke v. Coburn Enter., Inc.*, 873 F.2d 1094, 1100 (8th Cir.1989); *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814-15 (11th Cir.1989); *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir.1982); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 961-62 (5th Cir.1981) (*en banc*); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023-25 (6th Cir.1979); *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir.1978) (assuming without deciding that recklessness was sufficient); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44-47 (2d Cir.1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044 (7th Cir.1977). Since § 78u-4(b)(2) refers to the

"required state of mind," it seems more likely to us that Congress did not object to the substance of the state of mind standard found in the law before the passage of the Act. If Congress had wanted to impose a more stringent scienter standard, we believe that it would have done so explicitly, just as it expressly changed the pleading requirements. Save the Ninth Circuit, all other circuits to have considered this issue have concluded that the substance remained unchanged. Accordingly, we will apply the same scienter standard now as we did prior to the passage of the PSLRA: "an extreme departure from the standards of ordinary care, [ ] which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Sundstrand Corp.*, 553 F.2d at 1045 (quotation removed) (applying the standard to omissions); see also *SEC v. Jakubowski*, 150 F.3d 675, 681-82 (7th Cir.1998) (applying the *Sundstrand* scienter standard in a case decided after the passage of the PSLRA).

While § 78u-4(b)(2) did not impose a more stringent substantive scienter standard, it did unequivocally raise the bar for pleading scienter. Not only must plaintiffs meet a particularity requirement; they must also meet a substantive requirement by pleading sufficient facts to create "a strong inference" of scienter. Congress did not, unfortunately, throw much light on what facts will suffice to create such an inference. Currently three different approaches toward the way to demonstrate the required "strong inference" exist among the courts of appeals. The Second and Third Circuits take the position that the statute adopted the Second Circuit's pre-PSLRA pleading standard for scienter, "and thus plaintiffs may continue to state a claim by pleading either motive and opportunity or strong circumstantial evidence of recklessness or conscious misbehavior." *Novak*, 216 F.3d at 309-10; *In re: Advanta Corp. Sec. Litig.*, 180 F.3d 525, 530-35 (3d Cir.1999). The Ninth and Eleventh Circuits disagree, believing that Congress considered, but ultimately rejected the

Second Circuit's approach, opting instead for a more onerous burden. See *Silicon Graphics*, 183 F.3d at 974 ("Congress intended to elevate the pleading requirement above the Second Circuit standard requiring plaintiffs merely to provide facts showing simple recklessness or a motive to commit fraud and opportunity to do so."); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir.1999) ("[B]ecause the clear purpose of the [PSLRA] was to curb abusive securities litigation, and because we believe that the motive and opportunity analysis is inconsistent with that purpose, we decline to adopt it.").

The remaining six circuits that have considered this issue take a middle ground, reasoning that "Congress chose neither to adopt nor reject particular methods of pleading scienter—such as alleging facts showing motive and opportunity—but instead only required plaintiffs to plead facts that together establish a strong inference of scienter." *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir.2003); accord *Green Tree*, 270 F.3d at 659-60 (8th Cir.2001); *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 411-12 (5th Cir.2001); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1261-63 (10th Cir.2001); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550-52 (6th Cir.2001) (*en banc*); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195-97 (1st Cir.1999). We find this position persuasive. While some legislators may have thought that they were adopting the Second Circuit's pre-PSLRA approach, others may have envisioned a stricter standard, and still others may have had yet another view. See *Advanta Corp.*, 180 F.3d at 533 (reviewing the PSLRA's legislative history and concluding that it is "contradictory and inconclusive"). In any event, "[l]egislation is an objective text approved in constitutionally prescribed ways; its scope is not limited by the cerebrations of those who voted for or signed it into law." *United States v. Mitra*, 405 F.3d 492, 495 (7th Cir.2005). The text of the statute states only that the complaint must support "a strong inference" of scienter.

Without more detailed instruction, we conclude that the best approach is for courts to examine all of the allegations in the complaint and then to decide whether collectively they establish such an inference. Motive and opportunity may be useful indicators, but nowhere in the statute does it say that they are either necessary or sufficient.

Another concern, independent of the question of what type of information will support a finding of scienter, is the degree of imagination courts can use in divining whether a complaint creates a "strong inference." The Sixth Circuit has said that "the strong inference requirement creates a situation in which 'plaintiffs are entitled only to the most plausible of competing inferences,' but that it does not mandate that the inference be 'irrefutable.'" *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir.2004) (quoting *Helwig*, 251 F.3d at 553). As the Sixth Circuit itself has hinted, however, this standard could potentially infringe upon plaintiffs' Seventh Amendment rights. See *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 683 n. 25 (6th Cir.2005) ("One might argue that for cases where a juror could conclude that the facts pleaded show scienter, but that conclusion would not be the most plausible of competing inferences, a Seventh Amendment problem is presented.").

While we express no view on whether the Sixth Circuit's approach is in fact unconstitutional, we think it wiser to adopt an approach that cannot be misunderstood as a usurpation of the jury's role. Instead of accepting only the most plausible of competing inferences as sufficient at the pleading stage, we will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent. "Faced with two seemingly equally strong inferences, one favoring the plaintiff and one favoring the defendant, it is inappropriate for us to make a determination as to which inference will ultimately prevail, lest we invade the traditional role of the

factfinder." *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1188 (10th Cir.2003). "Scienter is normally a factual question to be decided by a jury, but the complaint must at least provide a factual basis for its scienter allegations." *Cerner Corp.*, 425 F.3d at 1084-85. If a reasonable person could not draw such an inference from the alleged facts, the defendants are entitled to dismissal; the complaint would fail as a matter of law to meet the requirements of § 78u-4(b)(2). See *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1105 (10th Cir.2003) ("We [ ] understand a 'strong inference' of scienter to be a conclusion logically based upon particular facts that would convince a reasonable person that the defendant knew a statement was false or misleading.").

The final piece of the scienter puzzle is whether the scienter allegations made against one defendant can be imputed to all other defendants in the same action. The so-called "group pleading presumption" is "premised on the assumption that in cases of corporate fraud where the false or misleading information is conveyed in prospectuses, registration statements, annual reports, press releases, or other 'group-published information,' it is reasonable to presume that these are the collective actions of the officers." *Bridgestone Corp.*, 399 F.3d at 689. There is significant debate among the various circuits on the question whether the group pleading doctrine survived the heightened pleading requirements of the PSLRA, see *Southland Sec. Corp. v. Inspire Ins. Solutions, Inc.*, 365 F.3d 353, 364 (5th Cir.2004); *Cabletron Sys.*, 311 F.3d at 40, as well as among the district courts of this circuit. Compare *Danis v. USN Communications, Inc.*, 73 F.Supp.2d 923, 939 n. 9 (N.D.Ill.1999) (concluding that group pleading continues after the PSLRA) with *Chu v. Sabratek Corp.*, 100 F.Supp.2d 827, 835-37 (N.D.Ill.2000) (concluding that it does not). The answer, in our view, lies in the language of the statute. Section 78u-4(b)(2) requires that the complaint "state with particularity facts giving rise to a strong inference that *the defendant* acted with the required

state of mind." As the Fifth Circuit recently held, "PSLRA references to 'the defendant' may only reasonably be understood to mean 'each defendant' in multiple defendant cases, as it is inconceivable that Congress intended liability of any defendants to depend on whether they were all sued in a single action or were each sued alone in several separate actions." *Southland*, 365 F.3d at 365-66. See also *Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015, 1018 (11th Cir.2004) ("[W]e believe that the most plausible reading in light of congressional intent is that a plaintiff, to proceed beyond the pleading stage, must allege facts sufficiently demonstrating each defendant's state of mind regarding his or her alleged violations."). We find this reasoning persuasive. While we will aggregate the allegations in the complaint to determine whether it creates a strong inference of scienter, plaintiffs must create this inference with respect to each individual defendant in multiple defendant cases.

The district court found that the plaintiffs' complaint adequately alleged that Notebaert and Birck made false or misleading material statements in regards to the TITAN 5500, the TITAN 6500, and the company's past results. We have drawn the same conclusion with respect to Tellabs's future projections. We can now assess whether the complaint states, with respect to each of these actionable statements, facts that give rise to a strong inference of scienter. We conclude that the complaint meets this threshold for Notebaert, but not for Birck. Since Notebaert was acting within the scope of his position as CEO, his alleged knowledge of the falsity of his statements can be imputed to the corporate entity Tellabs. See *United States v. One Parcel of Land Located at 7326 Highway 45 North*, 965 F.2d 311, 316 (7th Cir.1992) ("Where a corporate agent obtains knowledge while acting in the scope of his agency, he presumably reports that knowledge to his corporate principal so the court imputes such knowledge to a corporation.").

First, as for the TITAN 5500, the Probe Research report revealed, "in or about early 2001," that the market for the TITAN 5500 had faded. In reaction to this news, Tellabs's marketing strategy department concluded that revenue from the TITAN 5500 would decline by about $400 million. According to one confidential source, a Tellabs market analyst who worked for the company throughout the class period, internal reports revealed by March 2001 that the market for the 5500 was drying up. Yet, in April 2001, Notebaert told financial analysts that "everything we hear from the customers indicates that our in-user demand for services continues to grow." While it is conceivable that Notebaert had yet to see the reports suggesting his company was in trouble ("in or about early 2001" is somewhat vague), the plaintiffs have provided enough for a reasonable person to infer that Notebaert knew that his statements were false. According to another confidential source, a Tellabs business manager, Notebaert stayed on top of the company's financial health through weekly conversations with his fellow executives. Given the significance of the TITAN 5500 and the number of reports suggesting that it was in trouble, we find it sufficiently probable that Notebaert had information suggesting that his statements were false. See *Green Tree*, 270 F.3d at 665 ("One of the classic fact patterns giving rise to a strong inference of scienter is that defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate.").

Creating the required strong inference that Birck knew about the 5500's market weakness is more difficult. On the one hand, he signed a letter in February 2001 informing investors that the 5500 was "still going strong." Plaintiffs also alleged generally that he regularly attended "town hall meetings" with Notebaert, that he (with Notebaert) had his "hands on the pulse," and that he knew the status of each product. Furthermore, Birck sold 80,000 Tellabs shares in the first week of February 2001, which the plaintiffs suggest

supplies circumstantial evidence that he knew that his February statement was false. On the other hand, undermining the inference of Birck's knowledge is the fact that it was not until March 2001 that the TITAN 5500's declining status was obvious, and Birck's last public comment regarding the 5500 was that February letter. This particular insider trading evidence also adds little to the overall picture. While insider trading may be sufficient circumstantial evidence of scienter, plaintiffs must show that the sale of stock is "dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information." *Silicon Graphics*, 183 F.3d at 986 (internal quotation omitted); see also *Cerner Corp.*, 425 F.3d at 1085. Here, the plaintiffs allege that Birck made a significant stock sale, but the complaint provides no information as to how this sale compared to Birck's past or subsequent trading. Indeed, while 80,000 shares may be a lot of shares, it represented only one percent of Birck's holdings. The complaint does not provide any reference point from which to judge Birck's sales, and we do not believe that the mere fact that he sold one percent of his stock necessarily establishes a strong inference of scienter. Finally, the complaint fails to allege with particularity that Birck made any actionable statements regarding the TITAN 6500.

While we consider it a close question, we conclude that the plaintiffs did not meet the strict PSLRA standards for pleading Birck's scienter. We thus confine the remainder of our scienter discussion with respect to the 6500 to Notebaert. According to the complaint, Notebaert made a number of false statements regarding the 6500, suggesting that it was available and being shipped, when, in fact, Tellabs did not ship a single TITAN 6500 during the class period. If it is true that the TITAN 6500 was not in fact available during the class period, it is hard to accept that Notebaert's statements were simply honest mistakes. According to a Tellabs sales director, Notebaert saw weekly sales reports and production

projections. Another confidential source, a former high-level sales executive, reported that Notebaert knew that "the TITAN 6500 was not ready for deployment despite Tellabs'[s] public announcements." We conclude that the plaintiffs have pleaded sufficient facts to "giv[e] rise to a strong inference," 15 U.S.C. § 78u-4(b)(2), that Notebaert knowingly lied when he informed investors that the 6500 was "available now" and was "being shipped."

Although both Birck and Notebaert signed Tellabs's 10-K for the fourth quarter of 2000, once again the complaint does not contain enough information to create a strong inference that Birck recklessly disregarded the truth of Tellabs's financial health. According to the complaint, Tellabs fabricated the appearance of demand through channel stuffing. Although Birck should have assured himself that the numbers being represented were accurate, his trust in his CEO does not constitute the level of recklessness that the statute requires. The plaintiffs do, however, allege sufficient facts to suggest that Notebaert was aware of the channel stuffing. Indeed, a former senior business manager at Tellabs informed the plaintiffs that Notebaert "worked directly with Tellabs'[s] sales personnel" to effect the channel stuffing. Another confidential source, a high-level sales executive, admitted that his employees fabricated purchase orders for products that customers had not ordered. He claimed that Notebaert "unquestionably knew" about the channel stuffing. As with the TITAN 5500 and 6500, we find that the complaint contains enough detail to establish a strong inference that Notebaert knew of the channel stuffing and therefore knew Tellabs had exaggerated its fourth quarter 2000 revenues.

Finally, since the allegedly overstated revenue projections rest on the company's statements that its products were doing better than they actually were, the scienter for those alleged misrepresentations serves as sufficient circumstantial evidence of scienter here. Thus, the complaint is sufficient to

state a claim that Notebaert, but not Birck, recklessly disclosed overstated projections.

III

Both the Securities Act of 1933 and the Securities Exchange Act of 1934 impose liability not only on the person who actually commits the securities law violation, but also on the persons who "directly or indirectly" control the violator. See 15 U.S.C. § 78t(a). Thus, the plaintiffs' claims against Notebaert, Birck, and the other Tellabs executives for controlling person liability under § 78t(a) survive because the complaint adequately alleges a complaint against Tellabs, a "person" these individuals allegedly controlled. See *In re Stone & Webster, Inc. Sec. Litig.*, 424 F.3d 24, 27 (1st Cir.2005) (holding that "it is an essential element of the § 20(a) controlling person claims [in that case] . . . that plaintiffs show a Rule 10b-5 violation by the controlled entity"). While this is something of a back door to liability, given our finding that the complaint adequately alleges only that Notebaert acted with scienter, § 78t(a) allows a defendant to nullify control person liability by proving that he acted in "good faith." If, in the end, the plaintiffs are able to sustain a charge against Tellabs, Birck and the other executives will have an opportunity to prove that they acted in good faith.

The plaintiffs also pleaded a claim against Birck for insider trading. A private cause of action exists under § 20A of the Securities Exchange Act against persons who purchase or sell a security "while in possession of material, nonpublic information." See 15 U.S.C. § 78t-1(a). To create potential liability under § 20A, the plaintiffs must prove an independent violation of "this chapter or the rules or regulations thereunder." *Id.* In other words, § 20A claims are "derivative, requiring proof of a separate underlying violation of the Exchange Act." *Advanta Corp.*, 180 F.3d at 541. At this point in the litigation, we have affirmed the dismissal of the underlying securities fraud claims pleaded directly against

Birck. He still faces liability, but solely as a control person under § 20(a). Whether § 20(a) control-person liability standing alone can serve as the "separate underlying violation" required for § 20A insider trading is an open question of law and raises an important issue of statutory interpretation that should not be decided in a vacuum. No party in this litigation has provided more than cursory briefing of this issue, and therefore we take no position on its resolution, leaving it for further factual and legal development during the course of the litigation.

IV

For these reasons, we AFFIRM in part and REVERSE in part the judgment of the district court, and REMAND for further proceedings consistent with this opinion.

APPENDIX B

UNITED STATES DISTRICT COURT
N.D. ILLINOIS
EASTERN DIVISION

No. 02 C 4356

THOMAS JOHNSON,

Plaintiff,

v.

TELLABS, INC., MICHAEL J. BIRCK, RICHARD C. NOTEBAERT, ROBERT W. PULLEN, JOAN E. RYAN, BRIAN JACKMAN and JOHN C. KOLHER,

Defendants.

Feb. 19, 2004

MEMORANDUM OPINION AND ORDER

ST. EVE, *District Judge.*

Defendants have moved to dismiss the Second Amended Complaint pursuant to Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim. Their motion is granted.

This putative class action lawsuit is brought by various plaintiffs individually and on behalf of persons who purchased common stock of Defendant Tellabs between December 11, 2000 and June 19, 2001 (the "Class Period"). Plaintiffs[1] brought this purported class action alleging that Defendants engaged in a scheme to deceive and defraud

[1] On September 27, 2002, the Court appointed Makor Issues & Rights ("Makor Issues") Lead Plaintiff pursuant to 15 U.S.C. § 78u-4. *See Johnson v. Tellabs, Inc.*, No. 02 C 4356, 2002 WL 31163670 (N.D.Ill. Sept. 27, 2002).

investors as to the true value of Tellabs, Inc.'s ("Tellabs") common stock during the Class Period. Plaintiffs contend that Defendants carried out this scheme, in part, by falsely assuring investors about Tellabs' performance and prospects, engaging in fraudulent practices to artificially boost Tellabs' revenues and conceal the rapidly falling demand for Tellabs' products, selling shares of Tellabs' common stock at artificially inflated prices, and making false and misleading misrepresentations about Tellabs' current financial condition. Plaintiffs allege that these deceptive actions resulted in the artificial inflation of Tellabs' stock price which reached a high of $67.125 per share on February 5, 2001. Plaintiffs claim that they were injured when they purchased Tellabs' common stock at these artificially inflated prices.

On May 19, 2003, this Court granted Defendants' motion to dismiss Plaintiffs' Consolidated Amended Complaint in its entirely. *See Johnson v. Tellabs, Inc.*, 262 F.Supp.2d 937 (N.D.Ill.2003) (the "*May 19, 2003 Opinion*"). Plaintiffs filed their Second Amended Class Action Complaint (the "SAC") on July 11, 2003. Unlike their Amended Complaint, Plaintiffs' SAC identifies 27 confidential sources ("CS") who support various allegations.

In their SAC, Plaintiffs did not name the following individuals who were named in the Consolidated Amended Complaint: J. Thomas Gruenwald, Catherine Kozik, William F. Souders, and John Vaughn. Defendants now seek to dismiss the SAC in its entirety for failure to state a claim upon which relief can be granted pursuant to Federal Rule of Civil Procedure 12(b)(6), for failure to plead fraud with particularity pursuant to Federal Rule of Civil Procedure 9(b), and for failure to meet the pleading standards set forth in the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b) (the "PSLRA"). Given the additional detail added to the SAC and the extended analysis necessary to address this detail, the Court will repeat some of the facts set forth in its *May 19, 2003 Opinion*.

ALLEGATIONS

I. The Parties

Defendant Tellabs is a Delaware corporation with its principal place of business in Lisle, Illinois. (R. 63-1, SAC ¶ 16.) Tellabs designs, manufactures, markets, and services highly specialized optical networking, broadband access, and voice quality enhancement solutions. (*Id.* ¶ 2.) It is a global supplier of networking solutions and services that support the Internet. Tellabs' customers included exchange carriers, telephone companies, local telephone administrations, original equipment manufacturers, cellular and other wireless service companies, cable operators, alternate service providers, internet service providers, system integrators, government agencies, and business end-users. (*Id.* ¶ 2.) SBC Communications, Inc. ("SBC") and Verizon Communications, Inc. ("Verizon") were two of Tellabs' large customers. (*Id.* ¶ 2.)

The individual Defendants include: Michael Birck, Brian Jackman, John Kohler, Richard Notebaert, Robert Pullen and Joan Ryan (collectively, the "Individual Defendants"). Each of the Individual Defendants was an officer and/or director of Tellabs. Michael Birck, a founder of the company, was a director and served as chairman of Tellabs' board of directors since September 18, 2000. (*Id.* ¶ 17.) He also served as chief executive officer and president of Tellabs from 1975 through 2000. (*Id.*) Brian Jackman was a director of Tellabs and served as president of global systems and technology and executive vice president from 1998 through 2001. (*Id.* ¶ 18.) John Kohler was a senior vice president of global business operations from February 2000 to March 10, 2003, and a vice president of global manufacturing from 1992 through 2000. (*Id.* ¶ 19.)

Richard Notebaert served as a Tellabs' director from April 19, 2000 to June 17, 2002, and served as chief executive officer and president of Tellabs from September 18, 2000 to

June 17, 2002. (*Id.* ¶ 20.) Robert Pullen was a senior vice president and general manager of optical networking from August 2000 to February 2, 2002. (*Id.* ¶ 21.) Joan Ryan served as Tellabs' executive vice president and chief financial officer from February 2, 2000 to February 7, 2003. (*Id.* ¶ 22.)

Plaintiffs' SAC focuses on three of Tellabs' products: the TITAN 5500, the TITAN 6500 and the SALIX 7600. All of these products are complex transmission systems utilized with optical networking systems. The TITAN 5500, Tellabs' "flagship" optical networking system, is a digital cross-connect system that "help[s] direct different types of communications traffic across wired and wireless networks." (*Id.* ¶ 30.) The TITAN 6500 is a multi-service transport switch which is "capable of simultaneously transporting a variety of signal types." (*Id.* ¶ 31.) The SALIX 7600 is a switch "that enables service providers to move voice traffic seamlessly onto data networks while supporting voice services such as there-way calling and messaging." (*Id.* ¶ 32.)

II. Alleged Problems with Specific Products

Plaintiffs allege that the internet and telecommunications sectors suffered a significant decline in demand for their products in mid-2000. (*Id.* ¶ 3.) As a result, Tellabs' customers "were suffering from a severe deterioration and consolidation of their businesses." (*Id.* ¶ 4.) Given this decline, Plaintiffs allege that demand for Tellabs' products decreased. (*Id.* ¶¶ 3, 4.) Plaintiffs contend, however, that Defendants disguised the impact this decline had on Tellabs and falsely assured investors that Tellabs' performance was strong.

Plaintiffs allege that contrary to Defendants' public representations during the Class Period, the demand for the TITAN 5500—Tellabs' "best seller"—substantially slowed. (*Id.* ¶¶ 34-45.) Verizon and other clients significantly reduced their orders for the product. (*Id.* ¶¶ 35, 37.) As a result, in late 2000 and early 2001, Tellabs had "tons" of excess TITAN 5500s stored in a warehouse. (*Id.* ¶ 45.)

Similarly, Plaintiffs allege that the TITAN 6500 failed to sell as Tellabs had represented. (*Id.* ¶¶ 46-53.) They contend that Defendants touted a $100 million Sprint deal for the TITAN 6500 in order to foster a false impression that there was a demand for the product. (*Id.* ¶ 54.) Plaintiffs allege that Sprint entered this contract to satisfy an existing $100 million commitment to Tellabs, and that Sprint did not intend to purchase any TITAN 6500s beyond those in the agreement. (*Id.* ¶ 55.) Plaintiffs further contend that the TITAN 6500 was far behind schedule and not ready for release during the Class Period, was failing customer lab evaluations, and was inferior to other products offered by Tellabs' customers. (*Id.* ¶ 74.)

Plaintiffs also allege that the SALIX technology had serious technical defects and thus Tellabs could not commercialize it. (*Id.* ¶¶ 56-61.) They allege that Defendants "glowingly portrayed Tellabs' supposed 'launch' of its new 'leading edge' SALIX technology in 2000 when, in fact, the SALIX technology was both unfinished and outmoded." (*Id.* ¶ 56.) Plaintiffs contend that Defendants' statements regarding the prospects for the SALIX technology were false and misleading because they knew the SALIX technology was outmoded and could not be commercialized.

III. Allegedly False Statements by Tellabs

Plaintiffs claim that beginning on December 11, 2000 through the purported Class Period, Defendants made a series of false statements and omissions regarding Tellabs' fourth quarter 2000 financials, Tellabs' products, and its future prospects that resulted in the artificial inflation of Tellabs' stock price. Plaintiffs allege that the Individual Defendants are responsible for each of the statements.

A. December 2000

Tellabs issued a press release on December 11, 2000—the start of the purported Class Period—announcing a multi-year

sales agreement with Sprint for the TITAN 6500. "The agreement is expected to be valued at more than $100 million over the life of the contract." (*Id.* ¶ 73.) The press release noted that the "TITAN 6500 system is available now." On December 11, 2000, Tellabs also held a conference with securities analysts. On December 12, 2000, securities analysts summarized the conference and issued positive research reports on Tellabs. According to UBS Warburg, "Tellabs maintained its guidance for 4Q 2000 and all of 2001. In doing so, the company indicated that the demand for its Titan 5500 product line remain [sic] solid in 4Q and there is visibility for at least two years (if not more) of ongoing good growth for the product." (*Id.* ¶ 77.) It also estimated thirty-percent growth in sales for 2001. ABN AMRO reported Defendant Pullen commenting that "the TITAN 5500 remains the workhorse of the group and is expected to see strong growth for the next 2-3 years." (*Id.*) Baird & Co. reported that Tellabs "reiterated its confidence in the telecom-spending environment" and "reconfirmed consensus growth forecasts for fourth quarter 2000 and 2001." (*Id.* ¶ 76.) Notebaert, according to Baird & Co., "outlined the tremendous opportunity for Tellabs in international markets, as well as the expected continuing growth of the TITAN 5500, as well as its new optical-networking and next-generation switching initiatives." (*Id.* ¶ 76.)

B. January 23, 2001 Press Release

On January 23, 2001, Tellabs issued a press release announcing its financial results for the fourth quarter of 2000. (*Id.* ¶ 81.) Tellabs reported that "strength in Tellabs' core business drove record sales and earnings in the fourth quarter of 2000. Fourth-quarter 2000 sales totaled $1,018 million, up 42% from $716 million in 1999." (*Id.*) Notebaert explained, "[t]o keep up with robust growth in communications traffic, customers are buying more and more Tellabs equipment—fueling our records [sic] results and our first $1 billion

quarter." (*Id.*) The press release also reiterated Tellabs' $100 million multi-year agreement with Sprint to supply the TITAN 6500 system.

During a teleconference with securities analysts that same day, Notebaert stated: "[t]his was a great quarter and fitting end to a wonderful year.[2] Tellabs not only achieved record sales and profits in the fourth quarter [of 2000], we also set the stage for sustained growth with the successful launches of several products, many of those long anticipated . . . . Customers are embracing our products. We announced a $100 million plus agreement with Sprint for the 6500." (*Id.* ¶ 82.)

Notebaert also commented on the TITAN 6500. Specifically, he said that "[o]n the 6500, demand for that product is exceeding our expectations . . . . Demand is just . . . huge for this product." (*Id.* ¶ 84.) In an interview with Eric Schatzker from the Bloomberg News, Notebaert also commented: "I'm a little surprised at the performance of our stock the last few weeks, because last quarter, this quarter, we've been solid and we feel very, very good about the robust growth we're experiencing." (*Id.* ¶ 60.)

C. January 30, 2001 Press Release

Tellabs issued another press release on January 30, 2001, announcing "a new suite of softswitches, the SALIX 7600 softswitch control suite." (*Id.* ¶ 88.) The press release noted, "[w]ith the new SALIX 7600 suite, Tellabs has redefined the softswitch market and can now offer integrated, comprehensive solutions to all carriers." (*Id.*)

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[2] Defendant Joan Ryan also projected that "Tellabs will continue to sustain our strong record of growth" during the conference call. The Court previously dismissed this projection as protected by the PSLRA's safe harbor. *Tellabs*, 262 F.Supp.2d at 952.

D. February 14, 2001—Tellabs' 2000 Annual Report

On February 14, 2001, Tellabs issued its 2000 Annual Report. Notebaert and Birck issued a letter to stockholders in connection with the issuance of the Annual Report. (*Id.* ¶ 90.) In the letter, Notebaert and Birck represented that "Tellabs' growth is robust." (*Id.*) They stated that the TITAN 5500 continued with accelerating growth. They also stated that the TITAN 6500 "emerged from our laboratories in 2000, and customers are embracing it." Notebaert and Birck also stated that the TITAN 5500 is "still going strong," and the SALIX 7750 has a lot of opportunities. (*Id.* ¶ 91.)

The Tellabs' 2000 Annual Report contained a "Management Statement of Financial Responsibility," signed by Birck, Notebaert and Ryan. (*Id.* ¶ 94.) In that Statement, they represented that the "financial statements of Tellabs, Inc. and Subsidiaries have been prepared under the direction of management in conformity with generally accepted accounting principles." (*Id.* ¶ 94.)

E. March 2001

On March 7, 2001, Tellabs issued a press release announcing that it was lowering its revenue and earnings per share expectations for the first quarter 2001.[3] It noted that Tellabs could not recognize revenue from TITAN 6500 shipments in the first quarter but expected to do so in the second quarter of 2001. (*Id.* ¶ 99.) The press release stated that "[g]rowth in Tellabs' core optical networking business remains strong." (*Id.*)

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[3] The Court previously dismissed the projections in this press release as not actionable because they are protected by the PSLRA's safe harbor. *Tellabs*, 262 F.Supp.2d at 953. The Court also dismissed Notebaert's March 8, 2001 statement to analysts that "[w]e are as confident as ever—that may be an understatement—about the 6500" as puffery. *Id.* at 951.

During the conference call with securities analysts on March 8, 2001, Defendant Jackman explained, "[t]here's nothing in the revenue recognition issue that should be construed to imply that the testing and the customer's acceptance of these systems are having difficulty." (*Id.* ¶ 101.) With respect to the TITAN 5500, Notebaert told analysts "[w]e're still seeing that product continue to maintain its growth rate; it's still experiencing strong acceptance." (*Id.* ¶ 102.) When an analyst inquired about Tellabs' reaction regarding the lowered expectations of some of its competitors, Notebaert responded "we haven't gotten any indication, I haven't gotten any indication from any of our major clients, major customers, of a downturn in the segment we're in." (*Id.* ¶ 103.)

On March 29, 2001, Tellabs issued its 10-K for 2000[4], signed by Defendants Birck, Notebaert, Ryan and Jackman. The report noted: "[t]he Company achieved record levels in sales ($3,387.4 million), net earnings ($730.8 million) and earnings per share ($1.75)—putting it on track to meet its objective of $6 billion in annual revenues by the year 2003." (*Id.* ¶ 107.) It also stated that "[t]he growth in optical networking product sales was a result of continued strong demand for the Company's TITAN 5500/5500S and TITAN 532L digital cross connect systems." (*Id.* ¶ 109.)

The Form 10-K also favorably discussed the SALIX technology. (*Id.* ¶ 108.) "Leading the growth will be the Company's SALIX 7000 family of next-generation switching products." (*Id.* ¶¶ 107, 109.)

F. April 6, 2001

On April 6, 2001, Tellabs issued a press release lowering its first quarter earnings guidance. The press release stated,

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[4] The Court previously held that the projection contained in the 10-K regarding sales growth in 2001 is protected by the PSLRA's safe harbor. *Tellabs*, 262 F.Supp.2d at 952.

"[t]he revised guidance stems from reduced and deferred spending by major communications carriers late in the quarter." (*Id.* ¶ 113.)

On April 6, 2001, Notebaert and Ryan held a conference call with securities analysts. (*Id.* ¶ 114.) During the call, Notebaert told analysts that "[i]n just the last few weeks" Tellabs had experienced "a more controlled order of flow from our larger customers." (*Id.* ¶ 114.) He noted, however, that "everything we hear from the customers indicates that our in-user demand for services continues to grow." (*Id.* ¶ 114.) Notebaert added, "[t]he good news is, orders weren't canceled, they were pushed out into the next quarter." (*Id.* ¶ 116.) He stated that "the 6500 is showing strength . . . we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong." (*Id.* ¶ 117.) Ryan told analysts that "we see first quarter revenue of approximately $772 million, which represents a 21% year-over-year growth in overall revenue." (*Id.* ¶ 115.)

G. April 18, 2001

On April 18, 2001, Tellabs issued a press release announcing its first quarter financial results for the period ending March 31, 2001, and modified its revenue projections for 2001 from $3.99 billion to within the range of $3.6 billion to $3.7 billion. Tellabs further announced that it would "further reduce discretionary spending, eliminate salary increases this year, institute a pay-cut for all corporate officers, align manufacturing capability with demand expectations, and terminate the SALIX next-generation-switching product effort." (*Id.* ¶ 121.) It also announced that it planned to reduce its workforce by approximately 550 people. (R. 49-1, Defs.' Mot. to Dismiss App. Ex. 18.) Finally, Tellabs stated that it was terminated the SALIX next-generation switching product effort. (R. 63-1, SAC ¶ 121.) Notebaert nevertheless

stated, "I am as confident as ever in Tellabs' long-term prospects and our ability to deliver strong revenue and earnings growth in the future." (*Id.* ¶ 121.)

H. May 2001

Tellabs filed its Form 10-Q for the period ending March 30, 2001 on May 8, 2001. In the Form 10-Q, Tellabs stated that it had "achieved record first quarter 2001 sales of $772.1 million." Tellabs stated that the TITAN 5500/5500s drove the sales. (*Id.* ¶ 124.)

On May 31, 2001, Tellabs announced that it planned to take a $262 million restructuring charge in the second quarter of 2001. (*Id.* ¶ 128.) $93 million of the charge was related to the Company's termination of the SALIX next-generation switching business. (*Id.* ¶ 128.)

I. June 2001[5]

On June 19, 2001, which is the close of the purported Class Period, Tellabs issued a press release revising its second quarter guidance and reducing its revenues by approximately $300 million to $500 million. (*Id.* ¶ 131.) The press release explained the following:

> "The dramatic changes affecting the landscape of the telecommunications marketplace have continued to impact Tellabs. Service providers . . . are only buying equipment to meet the immediate needs of their customers. 'While we continue to see caution from our customers in the place of equipment deployment, our market position remains intact, and we are focused on

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[5] The Court previously held that Plaintiff had not alleged anything false about a press release issued on June 5, 2001 regarding the TITAN 6500. *Tellabs*, 262 F.Supp.2d at 951. Plaintiffs still do not particularize anything false about the release which generally discusses the TITAN 6500 and notes that it uses "the most innovative cell-based switching fabric with electrical and optical capabilities for converged services." (R. 63-1, SAC ¶ 129.)

> ensuring the most profitable path through the current environment,' said Tellabs President and CEO Richard C. Notebaert."

Id. Tellabs common stock fell from a high of $21.20 per share on June 19, 2001 to a low of $15.87 per share on June 20, 2001. (*Id.* ¶ 135.) The stock closed at $16.04 on June 20, 2001. (*Id.* ¶ 135.) The June 20, 2001 price reflected a decline of more than 75% "from the Class Period high of $67.125." (*Id.* ¶ 135.)

IV. Stock Sales

Plaintiffs allege that Defendants Birck, Kohler and Kozik sold approximately 150,000 shares Tellabs' common stock at artificially inflated prices during the purported Class Period, and received proceeds in excess of $8,000,000 from their sales. During the Class Period, Plaintiffs claim that Birck sold 80,000 shares for $5,183,150; Kohler sold 7,500 shares for a net profit of $466,218.75; and Kozik sold 3,220 shares for a net profit of $67,783.25. (*Id.* ¶ 144.)

ANALYSIS

The SAC contains seven counts. Plaintiff "inadvertently" named two unnamed defendants in Counts VI and VII. (R. 78-1, Pls.' Opp. to Motion to Dismiss, p. 39 n. 32.) Accordingly, the Court dismisses Counts VI and VII. Count I alleges that Defendants violated Section 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5, which caused Plaintiffs and other class members to suffer damages in connection with the purchase of Tellabs stock during the class period. They allege that Defendants disseminated materially false and misleading statements and concealed material adverse facts about Tellab's financial condition and future prospects in order to deceive the investing public as to the true value of Tellabs' stock and to cause Plaintiffs to purchase Tellabs' stock at artificially inflated prices.

Count II alleges that the Individual Defendants are "control persons" who violated Section 20(a) of the Exchange Act. Count III, brought on behalf of the LeBrun-Leehey Subclass[6], alleges that Birck and Kohler violated Section 20A of the Exchange Act by insider trading. Count IV, brought on behalf of the Broholm Subclass[7], alleges that Birck violated Section 20A of the Exchange Act. Finally, Count V, brought by Plaintiff Morris on behalf of the Morris Subclass[8], also alleges that Birck violated Section 20A of the Exchange Act. Defendants have moved to dismiss the Complaint in its entirety with prejudice.

As an initial matter, Plaintiffs raise multiple arguments in their opposition to Defendants' motion that the Court ruled on in its *May 19, 2003 Opinion.* To the extent Plaintiffs ask the Court to reconsider its prior rulings, "[m]otions for reconsideration serve a limited function: to correct manifest errors of law or fact or to present newly discovered evidence." *Publishers Resource, Inc. v. Walker-Davis Publications, Inc.*, 762 F.2d 557, 561 (7th Cir.1985) (quotation omitted); *see also In re Oil Spill by "Amoco Cadiz" Off Coast of France on March 16, 1978*, 794 F.Supp. 261, 267 (N.D.Ill.1992) ("[M]otions to reconsider are not at the disposal of parties who want to 'rehash' old arguments.").

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[6] The purported LeBrun-Leehey Subclass consists of all Class members who purchased Tellabs common stock contemporaneously with sales of Tellabs common stock by Defendants Birck and Kohler on February 2, 2001 (R. 63-1, SAC ¶ 173a.)

[7] The purported Broholm Subclass consists of all Class members who purchased Tellabs common stock contemporaneously with sales of Tellabs common stock by Defendant Birck on February 5, 2001. (*Id.* ¶ 173b.)

[8] The purported Morris Subclass consists of all Class members who purchased Tellabs common stock contemporaneously with sales of Tellabs common stock by Defendant Birck on February 6, 2001. (*Id.* ¶ 173c.)

Motions to reconsider are not appropriate vehicles to advance arguments already rejected by the Court or new legal theories not argued before the ruling. *Scharlte v. Motorola, Inc.*, No. 93 C 5508, 1994 WL 323281, at *1 (N.D.Ill. June 24, 1994). Plaintiffs have not provided the Court with any reason to revisit its prior rulings here.

I. Legal Standard

The purpose of a motion to dismiss pursuant to Rule 12(b)(6) is to test the legal sufficiency of a complaint, not the merits of the case. *See Triad Assocs., Inc. v. Chicago Hous. Auth.*, 892 F.2d 583, 586 (7th Cir.1989). When considering a motion to dismiss, the Court considers "whether relief is possible under [any] set of facts that could be established consistent with [the] allegations." *Bartholet v. Reishauer A.G. (Zurich)*, 953 F.2d 1073, 1078 (7th Cir.1992). The Court views the complaint "in the light most favorable to the plaintiff, taking as true all well-pleaded factual allegations and making all possible inferences from those allegations in his or her favor." *Lee v. City of Chicago*, 330 F.3d 456, 459 (7th Cir.2003). *See also Thomas v. Law Firm of Simpson & Cybak*, 354 F.3d 696, 697 (7th Cir.2004). The Court is not, however, "obliged to accept as true legal conclusions or unsupported conclusions of fact." *Hickey v. O'Bannon*, 287 F.3d 656, 658 (7th Cir.2002).

II. Securities Fraud Pleading Requirements

Allegations of securities fraud must meet the heightened pleading requirements of Federal Rule of Civil Procedure 9(b) as well as the strict pleading mandates of the PSLRA. Rule 9(b) requires Plaintiffs to plead "the circumstances constituting fraud . . . with particularity." *In re HealthCare Compare Corp. Sec. Litig.*, 75 F.3d 276, 281 (7th Cir.1996). As this Court previously noted, "this means the who, what, when, where, and how: the first paragraph of any newspaper story." *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir.1990).

A. The PSLRA's Heightened Pleading Requirements

In order to meet the PSLRA's dictates for a securities fraud claim, "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1).[9] The PSLRA also strengthened the pleading requirements for scienter in a securities fraud case: "In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). If a complaint failed to meet either of these requirements under the PSLRA, the Court "shall, on the motion of any defendant, dismiss the complaint." 15 U.S.C. § 78u-4(b)(3)(A). "Congress enacted this more stringent pleading standard 'to curtail the filing of meritless lawsuits' and to create a uniform pleading standard among the circuits." *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 343, (4th Cir.2003), quoting H.R. Conf. Rep. No. 104-369, at 41 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 740.

B. Pleading on Information and Belief

The PSLRA does not require Plaintiffs to plead all of their evidence or try their case at the pleading stage. The PSLRA requires that where allegations are based on "information and belief," "the complaint shall state with particularity all facts upon which that belief is formed." 15 U.S.C. § 78u-4(b)(1).

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[9] The PSLRA also raised a plaintiff's pleading requirement for scienter, *see* 15 U.S.C. § 78u-4(b)(2), as the Court discusses *infra* in Section III.B.

In its *May 19, 2003 Opinion*, the Court adopted the Second Circuit's approach articulated in *Novak v. Kasaks*, 216 F.3d 300, 313-14 (2nd Cir.2000), to information and belief pleading. The Court noted that "where plaintiffs rely on confidential sources but also on other facts, they need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants' statements were false." *Id.*, 216 F.3d at 314. The facts alleged in the complaint must be "sufficient to support a reasonable belief as to the misleading nature of the statement or omission." *Id.* at 314 n. 1. *See also In re Cabletron Sys., Inc.*, 311 F.3d 11, 29 (1st Cir.2002) ("The approach we take, similar to *Novak*, is to look at all of the facts alleged to see if they provide an adequate basis for believing that the defendants' statements were false.") (internal quotation marks omitted). Thus the Court will evaluate whether the factual allegations particularize and support Plaintiffs' allegations that fraud occurred.

In evaluating the allegations based on confidential sources, the Court will assess the reliability of each source's information based, in part, on the confidential source's position at Tellabs, the time period such he held such a position, his access to information and whether the allegations are based on his personal belief. The disclosure of information regarding confidential sources may be "helpful in distinguishing whether a particular allegation is mere rumor and speculation or whether it is based on concrete information from relevant documents or people who were in a position to know the truth of the allegations." *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1101 (10th Cir.2003).

Plaintiffs challenge the Court's holding and suggest that because their allegations are "based upon the investigation of Plaintiffs' counsel"—as opposed to based on information and belief—that their complaint need not state with particularity the facts on which their beliefs are formed. (R. 78-1, Opp. p. 5 n. 10). Plaintiff, however, makes a distinction without a

difference, however. Federal Rule of Civil Procedure 11 requires counsel to investigate all claims before filing a complaint, even those based on information and belief. Fed.R.Civ.P. 11(b). This Court rejects Plaintiffs' position and finds that allegations based upon counsel's investigation must state facts with the same particularity as if the claims were based on information and belief. As the Tenth Circuit recently noted, "For this court to rule otherwise would elevate form over substance and allow plaintiffs to avoid the [PSLRA]'s mandate merely by cloaking with a license to practice law the information and belief on which a complaint is based. Rule 11 of the Federal Rules of Civil Procedure provides that, by presenting a pleading, motion, or other paper to a court, an attorney is certifying that he has conducted 'an inquiry reasonable under the circumstances.'" *Adams*, 340 F.3d at 1098.

C. Group Pleading

In its *May 19, 2003 Opinion*, the Court addressed the applicability of the group pleading doctrine since the enactment of the PSLRA. As previously held, the group pleading doctrine does not survive with respect to allegations of scienter. *Tellabs*, 262 F.Supp.2d at 954. Instead, Plaintiffs must make specific allegations regarding each Defendant's scienter. *Id.*

With respect to the alleged misrepresentations made by Defendants, the Court noted that "[i]t is not entirely clear what effect the PSLRA has on the group pleading doctrine with respect to holding individual defendants" liable for statements by the company. Even if the group pleading doctrine survives the PSLRA in some form, however, it is apparent that the statute requires Plaintiffs to allege facts that support an inference that the statement is attributable to individual defendants. The PSLRA obligates a plaintiff to allege specific facts as to each of the defendant's mis-

representations or omissions. *Id.* at 946 (citing 15 U.S.C. § 78u-4(b)(1)).

III. Forward-Looking Statements

In its *May 19, 2003 Opinion*, the Court dismissed the majority of Plaintiffs' claims regarding Tellabs' revenue projections because the PSLRA's safe harbor affords protection to such projections. *Tellabs*, 262 F.Supp.2d at 952-954. Namely, the Court held that these forward-looking statements were "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." *Id.*, citing 15 U.S.C. § 78u-5(c)(1)(A)(i) & (ii). Plaintiffs' attempts to resurrect these same projection allegations in their SAC fail. The Court has already rejected these arguments and Plaintiffs have failed to provide any reason for the Court to reconsider its May 19, 2003 ruling. The Court's prior ruling stands with respect to the forward-looking statements made on January 23, 2001, March 7, 2001, March 29, 2001, April 6, 2001, and April 18, 2001. These claims are protected by the PSLRA's safe harbor and therefore are dismissed with prejudice.[10]

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[10] Plaintiffs claim that the safe harbor is inapplicable because these statements were made with actual knowledge of their falsity. Other courts have rejected this argument. *See Miller v. Champion Enterprises, Inc.*, 346 F.3d 660, 672 (6th Cir.2003) (state of mind is "irrelevant" for forward-looking statements accompanied by meaningful cautionary language); *In re Compuware Sec. Litig.*, No. 02-73793, 2004 WL 231464, at *7 (E.D.Mich. Feb.3, 2004) (same); *Sandmire v. Alliant Energy Corp.*, 296 F.Supp.2d 950 (W.D.Wis.2003) ("Such knowledge and the state of mind of the defendants at the time the statement was made are irrelevant to a safe harbor defense based on cautionary language"). Given that Plaintiffs have failed to plead a strong inference of actual knowledge, the Court need not decide this issue.

A. The December 12, 2000 Revenue Projection

The Court, however, did not reach this conclusion with respect to Tellabs' projection of 30% growth for 2001 made during a December 12, 2000 analyst call because the parties did not provide a transcript of that conversation for the Court to analyze whether any cautionary statements were made at the time of the projection. Defendants have still failed to provide such a transcript. Defendants argue that the Court nonetheless should dismiss this projection because Plaintiffs' allegations do not support that the projection was unreasonable when made.[11] The Court therefore proceeds to an analysis of scienter with respect to this statement.

B. Scienter for Forward-Looking Statements

In order for projections to be actionable, Plaintiffs must allege that Defendants made them with "the knowledge that they are incorrect or are otherwise without reasonable basis." *Katz v. Household Int'l., Inc.*, 91 F.3d 1036, 1039 (7th Cir.1996). "Projections which turn out to be inaccurate are not fraudulent simply because subsequent events reveal that a different projection would have been more reasonable." *In re HealthCare Compare*, 75 F.3d at 281. Under the PSLRA, a forward-looking statement is actionable against a person only where it "was made with actual knowledge by that person that the statement was false or misleading." 15 U.S.C. § 78u-5(c)(1)(B)(i); *see also Employers Teamsters Local Nos. 175 and 505 Pension Trust Fund v. Clorox Co.*, 353 F.3d 1125, 1133 (9th Cir.2004) (actual knowledge required for forward-looking statements); *Theoharous v. Fong*, 256 F.3d 1219, 1225 (11th Cir.2001) (With respect to forward-looking

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[11] Defendants do not argue that the "total mix" of information available to investors on December 12, 2000 included cautionary language that would protect this statement. *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1122-23 (10th Cir.1997); *Stavros v. Exelon Corp.*, 266 F.Supp.2d 833, 844 (N.D.Ill.2003).

statements, "the plaintiff must prove that the defendant made the statement with 'actual knowledge' that it was 'false or misleading.'"); *Stavros v. Exelon Corp.*, 266 F.Supp.2d 833, 847 (N.D.Ill.2003) (Plaintiffs must plead facts that show "a strong inference that Defendants actually knew" their projections were false or misleading.). A forward-looking statement is actionable against a corporation such as Tellabs if it was "made by or with the approval of an executive officer of that entity," and it was "made or approved by such officer with actual knowledge by that officer that the statement was false or misleading." 15 U.S.C. § 78u-5(c)(1)(B)(ii). In order to survive a motion to dismiss the December 11, 2000 forward-looking statement, "[p]laintiff must plead with particularity facts that strongly imply that Defendants actually knew that the projections were false or misleading when they made them." *Stavros*, 266 F.Supp.2d at 847.

Plaintiffs allege that Defendants knew on December 11, 2000 that the projection of 30% sales growth for 2001 was false and misleading because Tellabs was experiencing a substantial decline in demand for the TITAN 5500 at the time and was engaging in channel stuffing activities to fraudulently conceal that decline. They further contend the projection was false because the TITAN 6500 was not available, was far behind schedule, and was failing laboratory evaluations.

The December 2000 projection claim is dismissed with respect to Defendants Birck, Ryan, Jackman, and Kohler. Plaintiffs do not specifically allege that these Defendants were even aware of the December 11, 2000 earnings projection. Plaintiffs do not particularize their allegations of actual knowledge regarding these Defendants, and they fail to link the projection to these Defendants.

Plaintiffs allege that Defendants Notebaert and Pullen attended the December 11, 2000 analyst conference where the

projection was made. As discussed in detail below, Plaintiffs do not allege sufficient facts to support a strong inference that Pullen was reckless, much less that he had actual knowledge that the projection was incorrect. Accordingly, the Court dismisses Pullen with respect to this projection.

With respect to Notebaert, Plaintiffs' allegations also fail to support a strong inference of actual knowledge of falsity or baselessness. As discussed below, Plaintiffs' group pleading allegations and conclusory statements do not satisfy the PSLRA's scienter requirements for projections.

Given that Plaintiffs have failed to create a strong inference that the December 11 projection was made by any officer with actual knowledge that the statement was false or misleading, Plaintiffs' claim against Tellabs for the December 11, 2000 projection also fails.

IV. Alleged Misrepresentations

Plaintiffs allege that Defendants made a series of false and misleading statements regarding their financial performance and the success of their products. Plaintiffs alleged misrepresentations fall into the following categories: 1) statements regarding demand for the TITAN 5500; 2) statements concerning the TITAN 6500; 3) statements regarding the SALIX technology; and 4) statements regarding Tellabs' fourth quarter 2000 financials. The Court will address each of these categories.

A. Statements Regarding the TITAN 5500

Plaintiffs allege that Defendants made a series of misrepresentations regarding the status of the TITAN 5500. Plaintiffs allege that these statements were false because demand had dropped for the TITAN 5500, Defendants engaged in deceptive practices to disguise the decrease in demand, and Tellabs' internal reports confirmed the decline in demand. The Court will review each of the statements about the TITAN 5500 below.

The Court previously found that Notebaert's general, non-product specific statement that "[w]e feel very, very good about the robust growth we're experiencing" constituted mere puffery. *Tellabs*, 262 F.Supp.2d at 951. Plaintiffs have not provided any argument for the Court to reconsider this ruling. As the Seventh Circuit has noted, "[m]ere sales puffery is not actionable under Rule 10b-5." *Eisenstadt v. Centel Corp.*, 113 F.3d 738, 746 (7th Cir.1997). *See also Gallagher v. Abbott Labs.*, 269 F.3d 806 (7th Cir.2001) (holding vague statements and statements of puffery, such as general predictions of success are not actionable).

Similarly, the statement "demand for our core optical products, or our core networking products remains strong ..." is also puffery. That general statement does not specifically refer to any one product, including the products Plaintiffs identify as the backbone of their complaint. *See In re Splash Tech. Holdings, Inc. Sec. Litig.*, 160 F.Supp.2d 1059, 1077 (N.D.Cal.2001) (Statements describing "strong" demand, "better than expected," or "robust" results, a growth strategy that "was unfolding as planned," a "well positioned" company, a "solid" company position, and an "improved" product line are nonactionable puffery; further, "statements which used the words 'healthy,' 'strong,' or 'increased awareness' constitute[ ] vague assessments of past results, on which no reasonable investor would rely."); *Next Century Communications Corp. v. Ellis*, 318 F.3d 1023, 1028 (11th Cir.2003) ("strong performance" statement was mere puffery); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 206-07 (1st Cir.1999) ("upbeat statements of optimism," "excellent performance," and "increased" sales are not actionable); *Asher v. Baxter Intern., Inc.*, No. 02 C 5608, 2003 WL 21825498, *16 (N.D.Ill. July 24, 2003) ("the overall financial dynamic for Baxter is very strong"—is mere puffery); *Kafenbaum v. GTECH Holdings Corp.*, 217 F.Supp.2d 238, 250 (D.R.I.2002) (statements that a company is "on course to restore growth in the business . . ." and that the company

"remains confident that our business is sound" are not actionable); *Simon v. Am. Power Conversion Corp.*, 945 F.Supp. 416, 428 (D.R.I.1996) (statement that "we are gaining market share, we are gaining momentum, and our revenues are strong" is puffery). Pullen's December 2000 statement also falls in this puffery category: "[t]he TITAN 5500 remains the workhorse of the group and is expected to see strong growth for the next 2-3 years." (R. 63-1, SAC ¶ 77.) Likewise, Notebaert's December 2000 statement that the company "expected continuing growth of the TITAN 5500" is also non-actionable puffery. (*Id.* ¶ 76.)

The statement "[a]lthough we introduced this product nearly 10 years ago, it's still going strong because we keep adding new capabilities so it can do more and more for our customers" is also puffery because Plaintiffs have not made any allegations that the TITAN 5500 did not grow and improve over a 10 year period. Plaintiffs' allegations are instead focused primarily on the fourth quarter of 2000.

The more troubling statements based on the allegations in the case are those specifically referring to the success of the TITAN 5500 during the Class Period. On March 8, 2001, in response to a question from a Deutsche Bank analyst as to whether Tellabs was experiencing any weakness in the TITAN 5500 sales, Notebaert responded: "[w]e're still seeing that product continue to maintain its growth rate; it's still experiencing strong acceptance." (*Id.* ¶ 102.)

As discussed in detail below, Plaintiffs allege that Defendants fraudulently misrepresented Tellabs' financial condition. They allege that Defendants engaged in channel stuffing and other deceptive practices to disguise the decrease in demand for the TITAN 5500 in the fourth quarter of 2000. Given these allegations regarding the underlying financials, the Court will not dismiss these alleged statements as mere puffery.

B. Statements Regarding the TITAN 6500

During the purported Class Period, Defendants made numerous statements regarding the TITAN 6500. Plaintiffs allege that these statements regarding the TITAN 6500 were false and misleading because there was a lack of demand for the product, the TITAN 6500 was significantly behind production schedule, customers did not accept the product, and the TITAN 6500 failed customer and laboratory trials. Plaintiffs support their allegations with information from numerous confidential sources who worked at Tellabs.

The Court previously found that Notebaert's statement, "on the 6500, demand for that product is exceeding our expectations . . . ." is puffery. (*Id.* ¶ 84.) *See In re Allaire Corp. Securities Litig.*, 224 F.Supp.2d 319, 331 (D.Mass.2002) (statement that product "exceeded our expectations since it became generally available in December" is "clear puffery"). "It is hard to imagine a more subjective or vague statement than 'exceeded our expectations.'" *Id.* The Court's prior ruling stands. Furthermore, the statement "[w]e are as confident as ever—that may be an understatement—about the 6500" is also puffery.

Plaintiffs allege that a series of statements regarding a contract with Sprint for the TITAN 6500 are false and misleading. On December 11, 2000, Defendants issued a press release announcing a multi-year sales agreement with Sprint for the TITAN 6500. The press release announced that the "agreement is expected to be valued at more than $100 million over the life of the contract." (R. 63-1, SAC ¶ 73.) In January 2001, Notebaert stated that the Sprint deal was Tellabs' "first customer success with this new product."

Plaintiffs allege that this press release is misleading because Sprint's purchase of the TITAN 6500 "was merely to satisfy a pre-existing purchase obligation that arose when Sprint canceled another product purchase, and would not

result in continued sales." (*Id.* ¶ 74e.) This alleged motivation behind the contract, however, does not make the press release announcing the contract false.

Plaintiffs further allege that the December 11 press release is false because the TITAN 6500 was not available at the time and its production was "far behind schedule." (*Id.* ¶ 74.) The press release specifically noted: "[t]he TITAN 6500 system is available now." (*Id.* ¶ 73.) Plaintiffs have particularized through various confidential sources that the TITAN 6500 was not "available" for release in December 2000. Defendants argue that customers could have purchased the TITAN 6500 through contract at the time, even though the product may not have been available for shipment. The meaning of "available now" is a factual issue that the Court cannot properly decide on this motion to dismiss. The statement is therefore actionable.

Tellabs also made numerous statements during the purported Class Period about the TITAN 6500 sales that were not linked to the Sprint contract. For example, in its 2000 Annual Report, Tellabs said that its customers "are embracing" the TITAN 6500. (*Id.* ¶ 90.) This statement is mere puffery, and is not actionable despite the allegations that certain customers were not satisfied with the TITAN 6500 and it failed their lab tests. *See Scritchfield v. Paolo*, 274 F.Supp.2d 163, 181 (D.R.I.2003) (holding that defendant's claim of attaining "critical mass" of customers was non-actionable puffery).

On March 8, 2001, Notebaert said "[i]nterest in and demand for the 6500 continues to grow. . . . We continue to ship the . . . 6500 through the first quarter." We are satisfying very strong demand and growing customer demand. (R. 63-1, SAC ¶ 100.) These statements specifically pertain to the TITAN 6500 and the demand for the product. Plaintiffs have provided particularized allegations that contradict Defendants' affirmative representations regarding the demand,

acceptance, and development of the TITAN 6500. These statements pertain to a new product and its prospects for growth. Such misrepresentations are actionable. *See In re Allaire*, 224 F.Supp.2d at 331-32 (statements that newly developed product was "fueling growth" were actionable).

On April 6, 2001, an analysts inquired whether Tellabs was still on track to recognize TITAN 6500 revenue in the second quarter. Notebaert responded "we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong." (R. 63-1, SAC ¶ 117.) This statement is actionable for the reasons discussed above.

In a June 5, 2001 press release, Pullen announced that Tellabs was "enhancing [its] broadband networking systems to help service providers capitalize on the global business opportunities of today and tomorrow." He added that "[o]ur TITAN 6500 system is the industry's only carrier-class transport system that uses the most innovative cell-based switching fabric with electrical and optical capabilities for converged services." Plaintiffs fail to particularize how this statement about the product's characteristics is misleading. This statement is not actionable.

C. Statements Regarding the SALIX Technology

Plaintiffs have identified several statements regarding Tellabs' SALIX technology that they allege are actionable. Plaintiffs allege that Defendants falsely portrayed the SALIX technology as "leading edge" and successful during the purported Class Period. Plaintiffs allege that such statements were false and misleading because the "SALIX technology was both unfinished and outmoded." (*Id.* ¶ 56.) Plaintiffs contend that Tellabs "did not invest more money and personnel in the product" to commercialize it, as it needed to do. (*Id.* ¶ 57.) They further allege that in late April 2001, at a

"town hall" meeting, Defendant Notebaert "conceded that the SALIX technology was not current technology, and that there were other technologies that superceded it," according to a confidential source. (*Id.* ¶ 60.)

Plaintiffs identify four statements made prior to April 18, 2001 regarding the SALIX technology that they contend are false and misleading. First, Plaintiffs point to a January 30, 2001 statement describing the SALIX technology: "The SALIX 7600 suite brings together voice and data technologies to create a set of telepacket service applications that can help carriers grow profitably." (*Id.* ¶ 88.) In the same statement, Tellabs announced that it "can now offer integrated comprehensive solutions to all carriers." (*Id.* ¶ 88.) Even Plaintiffs acknowledge that Tellabs was selling the SALIX technology. (*Id.* ¶ 57.) Plaintiffs have not identified any falsities in this statement regarding the SALIX technology.

Second, Plaintiffs identify a statement in Tellabs' 2000 Annual Report that the "new SALIX 7750 next-generation switch positions Tellabs in a new category where we see a lot of opportunities." This "opportunities" statement is mere puffery. *See In re Peritus Software Services, Inc. Sec. Litig.*, 52 F.Supp.2d 211, 220 (D.Mass.1999).

The final two statements also appeared in the 2000 Annual Report. Tellabs noted "[o]ur new SALIX next-generation switches have built an enviable track record in this fledgling market." (*Id.* ¶ 92.) This statement is not misleading, especially in light of Tellabs' press release on January 23, 2001 announcing that the SALIX product group "generate $40 million in sales in the fourth quarter of 2000, down from $66 million a year ago." (R. 74-1, Def.'s Mot. to Dismiss SAC App., Ex. 1.) The Annual Report further noted that Tellabs "successfully launched five new products in 2000," including the "SALIX 7750 next-generation." (R. 63-1, SAC ¶ 93.) This reference is again corporate puffery that is not actionable.

Further, on April 18, 2001, *during the Class Period*, Defendants disclosed the very problems that Plaintiffs allege were withheld from the class. Specifically, Tellabs issued a press release announcing that it was "terminat[ing] the SALIX next-generation-switching product effort." (*Id.* ¶ 121; R. 49-1, Def.'s Mot. to Dismiss Comp.App., Ex. 18.) This is precisely what Notebaert disclosed in the "late April 2001" town hall meeting that Plaintiffs use as an example of withholding information from the public. Plaintiff cannot claim that Tellabs' stock price was artificially inflated during the purported Class Period based on alleged misrepresentations when Tellabs actually disclosed the basis of the alleged misrepresentation to the public *during* the Class Period. Materiality exists where "there is a substantial likelihood that disclosure of the information would have been viewed by the reasonable investor to have significantly altered the total mix of information." *Searls v. Glasser*, 64 F.3d 1061, 1066 (7th Cir.1995). Here, Tellabs disclosed the very information at issue *during* the purported Class Period. Plaintiffs have pled themselves out of court with respect to any statements made on or after April 18, 2001 pertaining to the SALIX technology.

D. Financial Results

Plaintiffs allege that Defendants falsely misrepresented Tellabs' financial results for the fourth quarter 2000 because Defendants were engaged in channel stuffing and other inappropriate activities involving the TITAN 5500[12] which inflated Tellabs' revenue figures and created a false picture of the demand for Tellabs' products.[13] As the Court previously

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[12] Plaintiffs do not allege that the TITAN 6500 or the SALIX technology contributed to the allegedly false financial statements.

[13] Although the SAC references Tellabs' first quarter 2001 financial statements, Plaintiffs do not allege anything false or misleading about these financials. Thus their veracity is not at issue in this lawsuit. Tellabs

noted, "channel stuffing" is the inducement of customers to substantially increase their purchases before they would otherwise buy products from the company in the normal course of business. *Tellabs*, 262 F.Supp.2d at 948 (citing *Greebel v. FTP Software*, 194 F.3d 185, 202 (1st Cir.1999)); *see also Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1184 (10th Cir.2003). Channel stuffing will "artificially inflate sales, which will then drop in the next quarter as the distributors no longer make orders while they deplete their excess supply." *Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1298 (9th Cir.1998).

Plaintiffs allege that Tellabs' over-inventoried customers with its TITAN 5500 product, knowing that it would result in drastically reduced sales and huge customer returns of unwanted merchandise in early 2001. Plaintiffs further allege that Defendants wrote orders for products that customers did not want, improperly back-dated orders and offered unusual and extraordinary discounts and incentives to customers to entice them to purchase products during the fourth quarter of 2000.

1. Over-Inventorying

Plaintiffs rely heavily on allegations that Tellabs over-inventoried it customers in order to falsely portray growing revenues and demand, and failed to disclose these facts to investors. Plaintiffs back their contentions with allegations supported by at least 8 separate confidential sources with personal knowledge that Tellabs provided customers with products that the customers did not want. (R. 63-1, SAC ¶¶ 63, 64, 65, 66, 67, 68, 69, 72.) These sources corroborate each other and suggest that the information is reliable. Plaintiffs identify specific customers whom Tellabs allegedly

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experienced a 21% increase in year to year growth in the first quarter of 2001.

over-inventoried, namely Telcobuy and Verizon[14]. They even allege that Verizon's Chairman called Tellabs to complain about the channel stuffing. They also identify the specific time periods of the over-inventorying—the fourth quarter of 2000.

Plaintiffs further allege that the channel stuffing of the TITAN 5500 was of an "extraordinary" magnitude. Plaintiffs allege that Notebaert worked directly with Tellabs' sales personnel to effectuate the channel stuffing. In addition, Plaintiffs allege that Tellabs engaged in these channel stuffing activities when they did not even have an agreement with the ultimate purchaser of the product. They further contend that although customers did not need the products, Tellabs shipped them anyway.

The SAC cures the defects in the Amended Complaint regarding the over-inventoried allegations by particularizing the allegations and naming supporting confidential sources. It alleges more than general conclusions.

2. Fictitious Sales

Plaintiffs allege that Tellabs engaged in recording fictitious sales of products. In support, Plaintiffs allege that CS-3, a high-level Tellabs sales executive, reported that Tellabs employees actually wrote purchase orders for customers for products that the customers had not ordered. This bare-bones allegation without any particularized facts the who, what, when or where does not meet the mandates of the PSLRA.

3. Back Dating Orders

Plaintiffs further allege that Defendants disguised the decline in demand for Tellabs' products by backdating sales.

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[14] Although Plaintiffs identify a third customer—Lexcom—they do not particularize any details about the alleged channel stuffing other than to say that Lexcom was "victimized by Tellabs' channel stuffing." (R. 63-1, SAC ¶ 71.)

In support, Plaintiffs allege that CS-1 stated that Defendants backdated sales, including pulling sales to larger customer such as SBC and Sprint from the first quarter 2001 into the fourth quarter of 2000 to make the numbers. Plaintiffs have particularized this allegation with support from a confidential source as well as examples.

4. Customer Incentives

Plaintiffs allege that Tellabs provided customers with sales incentives which were concealed from the investing public. They further contend that these incentives were excessive, unusual, and out of line with ordinary business practices.

In support of these allegations, Plaintiffs allege that CS-1, a former Tellabs marketing manager, reported that Tellabs got "creative" to make the numbers at the end of the fourth quarter of 2000 by offering customers discounts of as much as 10% to 20% and "other incentives" (*Id.* ¶ 69.) Additionally, CS-3 represented that Tellabs offered Telcobuy very generous credit terms (90 days), rather than the normal 30 days. Plaintiffs also allege that Tellabs gave "Telcobuy additional discount incentives to buy TITAN 5500 plugs in late 1999 through late 2000."

As previously noted by the Court, customer incentives are a frequent tool of conducting business and are not inherently improper. *Tellabs*, 262 F.Supp.2d at 950. Plaintiffs' allegations do not suggest that these incentives were improper. A 60-day extension of credit terms is not extraordinary in today's business world. Furthermore, Plaintiffs do not particularize the alleged "additional discount incentives."

Although Plaintiffs contend that these undisclosed incentives contradicted Defendants' public statements, they fail to identify any specific public statements that they contradict. Providing sales discounts and incentives, without more, certainly does not contradict statements of growth.

5. Allegations Taken as A Whole

It is clear that there may be "legitimate reasons for attempting to achieve sales earlier" by engaging in channel stuffing. *Broudo v. Dura Pharms., Inc.*, 339 F.3d 933, 940 (9th Cir.2003). Plaintiffs, however, have alleged that Defendants engaged in channel stuffing in order to falsely misrepresent their financial condition. Although several categories of Plaintiffs' allegations fail regarding channel stuffing, when viewing the totality of the SAC's allegations, Plaintiffs have sufficiently particularized their allegations that Defendants engaged in channel stuffing in order to falsely portray Tellabs' financials.

V. Scienter

A. Legal Standard for Scienter

The PSLRA requires that a plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Plaintiffs' Amended Complaint failed to allege scienter sufficient to meet the mandates of the PSLRA. Essentially, Plaintiffs had lumped their scienter allegations together as to all "Defendants." As the Court held in its *May 19, 2003 Opinion*, Plaintiffs must allege facts establishing that each Individual Defendant knew, or recklessly[15] ignored, that the statements were materially false or misleading. *Tellabs*, 262 F.Supp.2d at 954. This Court has rejected the Second Circuit's test for scienter where a plaintiff is required to allege either: (1) facts showing that the defendants had both motive and opportunity to commit fraud or (2) facts constituting strong circumstantial evidence of conscious

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[15] "Reckless conduct is, at least, conduct which is highly unreasonable and which represents an extreme departure from standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." *Rehm v. Eagle Fin. Corp.*, 954 F.Supp. 1246, 1255 (N.D.Ill.1997).

misbehavior or recklessness. *Id.* Instead, Plaintiffs may use "motive and opportunity" or "circumstantial evidence" to establish scienter under the PSLRA, only if Plaintiffs' allegations support a strong inference that each Defendant acted recklessly or knowingly. *Tellabs*, 262 F.Supp.2d at 954; *see also Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir.2003) ("[C]ourts should not restrict their scienter inquiry by focusing on specific categories of facts, such as those relating to motive and opportunity, but instead should examine all of the allegations in each case to determine whether they collectively establish a strong inference of scienter.").

B. Analysis

Defendants argue that Plaintiffs have failed to allege scienter under the mandates of the PSLRA. Plaintiffs claim that they have sufficiently alleged a strong inference that each of the Individual Defendants knew or recklessly disregarded the truth.

Plaintiffs again lump many of their scienter allegations together with broad statements regarding "Defendants" or the "Individual Defendants." They allege, for example, that "Defendants also knew or recklessly disregarded that the misleading statements and omissions . . . would adversely affect the integrity of the market for the Company's common stock." (R. 63-1, SAC ¶ 148.) They further allege that "Defendants had a power motive to inflate the price of Tellabs' stock." (*Id.* ¶ 150.) Further, they contend that the "Individual Defendants were senior executive officers and directors of Tellabs and were intimately involved with and had direct responsibility with respect to important issues affecting the Company's business, operations, products, performance, and prospects." (*Id.* ¶ 152.) In its Opinion, the Court clearly noted that "[g]roup pleading allegations are insufficient under the PSLRA to establish scienter on the part of each individual Defendant." *Tellabs*, 262 F.Supp.2d at

955. Thus, these allegations alone are insufficient to establish scienter under the PSLRA.

C. Scienter Based on Insider Trading

Plaintiffs again try to support their scienter allegations with contentions regarding the sale of Tellabs' stock by insiders. Specifically, Plaintiffs allege that two of the Defendants—Birck and Kohler—sold stock during the Class Period. They also allege that four other Tellabs' "insiders" sold stock during this time.

As the Court previously held, mere allegations of insider trading during the purported Class Period alone do not support a strong inference of scienter. *Tellabs*, 262 F.Supp.2d at 954. "Unusual" or "suspicious" stock sales by corporate insiders, however, may provide circumstantial evidence of scienter. *Id.; Broudo*, 339 F.3d at 940 ("[U]nusual stock or suspicious stock sales can serve as circumstantial inference of scienter."). In order to rise to the level of "unusual" or "suspicious," the insider trading must be "dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information." *In re Silicon Graphics, Inc.*, 183 F.3d at 986 (internal quotation omitted).

Plaintiffs fail to allege sufficient facts demonstrating that the sales by Defendants Birck and Kohler were unusual or suspicious. They do not allege the amount or percentage of overall shares sold by either of these Defendants. Indeed, at the time Defendant Birck sold 80,000 shares of common stock, he was the beneficial owner of over 37 *million* shares of Tellabs' common stock. (R. 74-1, Def.'s Mot. to Dismiss SAC App., Ex. 9). Birck's sales during the Class Period thus amount to less than 1% of his holdings. Plaintiffs do not allege the amount of profit Defendant Birck made on his sales. They also do not allege the history of trading on the part of these Individual Defendants.

Furthermore, the SAC focuses on Defendant Notebaert's allegedly fraudulent statements. Plaintiffs do not allege that CEO Notebaert sold stock during the Class Period. The absence of such allegations against him further weakens Plaintiffs' argument that the insider sales support a strong inference of scienter on the part of Notebaert. *See Druskin v. Answerthink, Inc.*, No. 02-23304, 299 F.Supp.2d 1307, 1336, 2004 WL 95402 at *22 (S.D.Fla. Jan.5, 2004).

Plaintiffs allegations of insider trading by other Tellabs' insiders who are not named as Individual Defendants also fail to support a strong inference of scienter. Plaintiffs assert that these sales "evidence senior management's knowledge of serious undisclosed problems." (R. 78-1, Pl.'s Opp. to Defs.' Motion to Dismiss SAC, p. 32 n. 26.) Plaintiffs fail to make any allegations connecting Catherine Kozik, Thomas Gruenwald, William Souders, or Peter Gugliemi to the fraudulent scheme. It would be a stretch, at best, to conclude based on the allegations in the SAC that the Individual Defendants engaged in the alleged scheme in order to financially benefit other insiders who were not part of that scheme. Thus, their sales do not bear on the issue of scienter.

D. Hands On Allegations

Plaintiffs also make numerous general statements regarding the "hands on" management at Tellabs in an attempt to establish scienter. They allege that "Tellabs' executives and directors were 'hands on' and knew everything, including the product development cycles, everyday happenings of the Company, and customer expectations." (R. 63-1, SAC ¶¶ 153-57.) Such general "hands on" allegations, however, are insufficient to establish scienter. *See In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1088 (9th Cir.2002).

E. Access to Reports

Plaintiffs also contend that a strong inference of scienter is established through the Individual Defendant's access to

reports. Tellabs' finance department generated internal quarterly status reports that were available on the company's database system regarding the profitability of Tellabs' products. These reports, according to a confidential source, "showed a decline in customer demand for the TITAN 5500 by March 2001." (R. 63-1, SAC ¶ 153e.) Plaintiffs also allege that the reports "showed declining demand in the third and fourth quarters of 2000 for a variety of Tellabs' products, including the TITAN 5500." (*Id.* ¶ 40.) Tellabs also generated daily reports concerning Tellabs' daily product bookings and revenues. Additionally, Tellabs generated weekly and monthly reports concerning various issues, including the status of product development. (*Id.* ¶ 153f.)

These general allegations alone—that Defendants received daily, weekly, and monthly reports—are insufficient to create a strong inference of scienter. *See Silicon Graphics*, 183 F.3d at 985. Mere access to internal data does not meet the dictates of the PSLRA. *See Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1035-6 (9th Cir.2002); *In re Apple Computer, Inc., Sec. Litig.*, 243 F.Supp.2d 1012, 1025 (N.D.Ca.2002); *Collmer v. United States Liquids, Inc.*, 268 F.Supp.2d 718, 753 (S.D.Tex.2003) (Mere access to reports was insufficient to plead scienter "without some additional facts such as exposure to content-identified internal corporate documents (and who drafted them, who received them or how plaintiffs learned of them) or specific conversations or attendance at specified management or board meetings dealing with such problems."); *see also Arazie v. Mullane*, 2 F.3d 1456 (7th Cir.1993) (finding internal documents insufficient to support fraud where the complaint did not indicate who prepared them, when they were prepared or what was precisely in them). Plaintiffs do not describe the contents of these reports or detail what such reports reflected. They do not allege who, other than the "finance department," prepared such reports. They do not allege any particularized facts showing how the information contained in the reports demonstrated the falsity

of Tellabs' fourth quarter financial results or sufficient facts regarding how the information supports any inference of knowledge of falsity.

With respect to the quarterly status reports, Plaintiffs contend that they showed a declining demand in the third and fourth quarters of 2000 "for a variety of Tellabs' products, including the TITAN 5500." (R. 63-1, SAC ¶ 40.) Plaintiffs, however, fail to allege what reports showed a decline in the demand and who received such reports. They also do not particularize what information was reflected in this report, how significant the decline in demand was, or how much of the decline was attributed to the TITAN 5500 as opposed to other products. The source of this information is also unclear. Although Plaintiffs allege that CS-23 "viewed" the quarterly reports, it is unclear that CS-23 provided this information. Moreover, CS-23 is a former Tellabs' engineer, thus it is unclear when or how he had access to the reports.

Additionally, Plaintiffs allege that a confidential source "revealed that these [quarterly] reports showed a decline in customer demand for the TITAN 5500 by March 2001." (*Id.* ¶ 153d.) This information in March of 2001, however, does not have any effect on the allegedly fraudulent fourth quarter 2000 financials and Plaintiffs do not allege that Tellabs' first quarter 2001 financials were fraudulent. Plaintiffs must include detailed information when basing their scienter allegations on a defendant's access to internal company reports. "The reason for requiring such detail [is] that every sophisticated corporation uses some kind of internal reporting system reflecting earlier forecasts, and that allowing a plaintiff to go forward with a case based on general allegations of 'negative internal reports' would expose all those companies to securities litigation whenever their stock prices dropped." *In re Vantive Corp. Sec. Litig.*, 283 F.3d at 1087-88 (citations and quotations omitted).

F. Probe Research Study

Plaintiffs allege that Probe Research, an independent research firm, performed a study for Tellabs. The study, according to CS-16, who worked as Tellabs' marketing strategy executive during the purported Class Period, "showed a steep drop in the number of T1 circuits required in the market." (R. 63-1, SAC ¶ 39.) According to CS-16, "T1' s were the main source of demand for Tellabs' TITAN 5500 systems." (*Id.*) Tellabs' marketing strategy department prepared an internal report in or about early 2001 concluding that "as a result of the decline in T1's, Tellabs' revenue from the TITAN 5500 would decline by approximately $400 million." (*Id.*)

This research was not completed until around early 2001—after Tellabs made its December 11, 2000 revenue projections. Significantly, the SAC does not detail when in 2001 Probe Research completed the study. It also does not state when the marketing strategy department completed and disseminated its report. Moreover, the report does not disclose when Tellabs' revenue would feel the effect of the drop in the T1 circuits and decline. Given the lack of these significant details, the Probe Research study allegations alone cannot support a strong inference of actual knowledge or recklessness.

G. Alleged Omission in Company's 2001 Annual Report

Plaintiffs claim that certain "admissions" by Tellabs support a showing of scienter. Specifically, in its 2001 Annual Report, dated January 22, 2002, Tellabs noted:

> Early in 2001, as our customers reduced capital spending and expressed caution about the future, Tellabs began a deep process of self-examination. We faced difficult decisions, the most onerous being our need to match capacity and expenses with demand to preserve profitability.

> Making a company smaller is painful. In April 2001 we began a series of layoffs, a process that continues through March 2002, reducing our worldwide workforce by about 27% to around 6,700 people. We closed manufacturing plants in Ireland and Texas, consolidated product development and other functions from 30 facilities into 20, and cut expenses dramatically.

(*Id.* ¶ 141.)

These post-class statements are completely consistent with statements made during the purported Class Period. On April 18, 2001, as alleged in Plaintiff's SAC, Tellabs issued a press release noting: "[i]n light of reduced and deferred spending by major communications carriers, Tellabs will realign its cost structure with its current expectations for lower revenue growth." (*Id.* ¶ 121.) The press release further noted that Tellabs would be "reducing its workforce by about 550 people . . . [that it had] eliminated 450 temporary or contract positions . . . and will not fill 1,100 open positions." (R. 85-1, Def.'s Reply Mem., Ex. D.) The Annual Report statements do not contradict the company's statements in April 2001. Therefore, the statements in the Annual Report do not support even a weak inference of scienter. *See e.g., In re Read-Rite Corp.*, 335 F.3d 843, 846 (9th Cir.2003).

H. Individual Defendants

The Court will now analyze whether Plaintiffs have alleged sufficient facts to establish that each Individual Defendant knew, or recklessly ignored, that the allegedly fraudulent statements were materially false or misleading. The Court will also address in this section whether each of the Individual Defendants is accountable for those statements remaining in the case. The PSLRA requires Plaintiffs to particularize the role of each Individual Defendant in the alleged misrepresentations. Plaintiffs must allege facts sufficient to support an inference that the misrepresentation was

made by or is attributable to a particular Individual Defendant or that the Individual Defendant had control over the content of the statement.

1. John Kohler

Kohler was the Senior Vice President of Global Business Operations during the Class Period. Plaintiffs do not allege that Kohler made any of the allegedly false statements at issue in this case. Instead, they use group pleading to assert that the statements are "the collective actions of the narrowly defined group of Defendants . . . by virtue of their high-level positions with the Company and 'hands on' management style." (R. 63-1, SAC ¶ 24.) They allege that "Defendants were involved in the fraudulent activities herein alleged and were also involved in drafting, producing, reviewing, and disseminating the materially false and misleading statements and information alleged herein; were aware, or recklessly disregarded, that the materially false and misleading statements were being issued regarding the Company; and approved or ratified these statements, in violations of the federal securities laws." (*Id.* ¶ 24.) Plaintiffs further assert that the "Individual Defendants, because of their positions of control and authority as officers and directors of the Company, were able to and did control the content of the various SEC filings, press releases, and other public statements pertaining to the Company during the Class Period." (*Id.* ¶ 27.) They allege that the Individual Defendants had copies of the documents and had the "ability and opportunity to prevent their issuance or cause them to be corrected." (*Id.* ¶ 27.)

Under the mandates of the PSLRA, the Court must evaluate the allegations concerning each of the Individual Defendants separately. Plaintiffs' broad, general allegations regarding Kohler's responsibility for statements made by other Defendants fall far short of sufficiently attributing the statements to him. Plaintiffs do not set forth sufficiently particularized allegations that Kohler knew about the statements

or had any control over them. They do not allege that Kohler controlled, or could have controlled, such statements. Plaintiffs further do not assert that Kohler drafted any of these statements or participated in the approval of such statements. In short, Plaintiffs have not pled specific facts connecting Defendant Kohler to any of the statements that are allegedly false and misleading. Thus, they cannot provide a basis for federal securities fraud liability against Kohler. Accordingly, Kohler is dismissed from Count I.

2. Robert Pullen

During the Class Period, Robert Pullen was Tellabs' Senior Vice President and General Manager of Optical networking. Plaintiffs have identified two allegedly false statements made by Pullen in their SAC. The first statement is one attributed to Pullen by ABN AMRO, Inc., following a December 11, 2000 conference with securities analysts. Pullen allegedly commented that the "TITAN 5500 remains the workhorse of the group and is expected to see strong growth for the next 2-3 years." But Plaintiffs do not particularize any scienter allegations against Pullen pertaining to the TITAN 5500. Plaintiffs only allege that Pullen had knowledge regarding the TITAN 6500. Additionally, as discussed above, the Court dismissed this statement as puffery. Accordingly, Plaintiffs have not met their scienter burden regarding this statement attributed to Pullen.

The second statement in the SAC attributed to Pullen is one made on June 5, 2001 regarding the TITAN 6500. As the Court noted above, however, this statement is mere puffery and thus not actionable.

With respect to those statements not made by Pullen, as with Kohler, Plaintiffs have failed to plead specific facts connecting Pullen to them. They use the same group pleading allegations noted above in an attempt to impose liability on Pullen for such statements. But these group

pleading allegations do not meet the mandate of the PSLRA. Plaintiffs have not particularized why or how Pullen should share responsibility for these statements. Accordingly, Count I is dismissed with respect to Defendant Pullen.

3. Joan Ryan

Ryan was Tellabs' Executive Vice President and Chief Financial Officer during the Class Period. Plaintiffs' allegations regarding Ryan's scienter are sparse. Plaintiffs allege that Ryan made quarterly presentations with respect to Tellabs' financial position at the "town hall" meetings. Given her financial position at the company, this duty is not surprising. Plaintiffs do not allege that Ryan did anything fraudulent or questionable at these meetings. They further do not allege that Ryan knew of the alleged problems with the products at issue.

Plaintiffs main allegation against Ryan is that she knew about the channel stuffing. As the Ninth Circuit recently noted, however, "channel stuffing claims may have some probative value insofar as the channel stuffing was done so as to artificially inflate income, but there may also be other legitimate reasons for attempting to achieve sales earlier." *Broudo*, 339 F.3d at 940. Furthermore, Plaintiffs have failed to plead particular facts supporting this general conclusion with respect to Ryan. They do not allege specific channel stuffing activities, when they took place, what customers these activities affected, or when she knew about them. These allegations do not factually link Ryan to any allegedly fraudulent statements. Although allegations regarding channel stuffing may be sufficient to allege a misrepresentation, Plaintiffs' conclusory allegations regarding Defendant Ryan's knowledge of channel stuffing, without more, cannot support a strong inference that she knew or recklessly ignored that the statements were materially false or misleading. *See Greebel*, 194 F.3d at 185 (concluding that channel stuffing allegations "[do] not support a strong inference of scienter"); *In re Splash*

Tech. Holdings Sec. Litig., 160 F.Supp.2d 1059, 1075-76 (N.D.Cal.2001); *Pirraglia v. Novell Inc.*, No. 2:99CV995C, 2000 WL 33194748, at *2-3 (D.Utah Nov.2, 2000) (finding that "channel stuffing" does not support a "strong inference" of scienter); *Fitzer v. Security Dynamics Tech., Inc.*, 119 F.Supp.2d 12, 36 (D.Mass.2000) (same); *In re Dura Pharm., Inc. Sec. Litig.*, No. 99CV0151-l(NLLS), 2000 WL 33176043, at *8 (S.D.Cal. July 11, 2000) (finding no strong inference of scienter from alleged "channel stuffing"); *In re Trex Co., Inc. Sec. Litig.*, 212 F.Supp.2d 596, 608 (W.D.Va.2002) ("Allegations of channel stuffing, standing alone, are insufficient to sustain the state of mind requirement in a securities fraud claim because 'there may be a number of legitimate reasons for attempting to achieve sales earlier' than in the normal course").

Plaintiffs suggest that they have alleged scienter because Ryan signed the company's SEC filings and financial statements. While Ryan is certainly accountable for the financial statements and SEC forms that she signed, that accountability alone does not automatically arise to the requisite level of scienter. *See In re Sunterra Corp. Sec. Litig.*, 199 F.Supp.2d 1308, 1330 (M.D.Fla.2002) (signatures on SEC Forms alone do not raise a strong inference of scienter). Plaintiffs must still meet the mandates of the PSLRA and properly allege a strong inference of scienter. They must provide particularized factual allegations that support a strong inference that Ryan knew or recklessly disregarded that the allegedly fraudulent statements and SEC forms were false or misleading when made. Plaintiffs have failed to do so with respect to Defendant Ryan.

In viewing the totality of the allegations against Ryan, Plaintiffs fall short of meeting their burden regarding scienter. Accordingly, Count I is dismissed with respect to Ryan.

4. Michael Birck

During the Class Period, Birck served as Chairman of the Board. Plaintiffs allege that Birck had his "hands on the pulse of everything" at Tellabs. (R. 63-1, SAC ¶ 154.) They contend that Birck communicated with employees at town hall meetings and heard sales personnel briefings concerning product status and other matters. They allege that he "knew the status of each product, how it was working, if the product was selling, and to whom from speaking with sales people . . . ." (*Id.* ¶ 154.) Plaintiffs also allege, according to a confidential source, that Harvey Scull, the head of Tellabs' mergers and acquisition group had conversations with Defendant Birck. Although Plaintiffs allege that Scull received information regarding market data and research and acquisition targets, they do not allege what information Scull provided to Birck, when he provided it, or the relevance of such information. Birck also signed the SEC Forms.

In essence, Plaintiffs' scienter allegations amount to the argument that Birck knew or recklessly disregarded the falsity of the statements because of his position with the Company, and that he sold less than 1% of his Tellabs' common stock holdings during the Class Period as discussed above. Given the mandates of the PSLRA, these allegations in their totality fall short of providing a strong inference of scienter. *See Advanta*, 180 F.3d 525, 539 (3rd Cir.1999) ("Generalized imputations of knowledge do not suffice, regardless of the defendants' positions within the company."). Birck is dismissed from Count I.

5. Brian Jackman

Jackman was President of Global Systems and Technology and Executive Vice President, as well as a Director, during the Class Period. Jackman had the responsibility for all product divisions worldwide.

Plaintiffs allege that Jackman reviewed daily reports concerning Tellabs' daily product bookings and revenue on a weekly basis. (R. 63-1, SAC ¶ 153e.) They contend that Jackman ran Tellabs prior to Notebaert's appointment as Tellabs' CEO "and all information flowed up" to him. Furthermore, Plaintiffs allege that "[a]s the head of Tellabs' 'Product House,' it was Jackman's responsibility to know what the market was doing so that he could invest in the right products to meet the market." (*Id.* ¶ 157.) Jackman "ran the whole product side of Tellabs' business. Jackman reported directly to Birck." (*Id.* ¶ 158.)

As an initial matter, Plaintiffs fail to allege that Jackman had any involvement with or knowledge regarding the alleged problems with the TITAN 5500. Instead, the scienter allegations regarding Jackman pertain only to the TITAN 6500. Plaintiffs have therefore not established that Jackman is liable for any of the alleged misrepresentations regarding the TITAN 5500.

According to CS-3, Jackman knew that the TITAN 6500 was not ready for development despite Tellabs' public announcements. (*Id.* ¶ 171.) Nonetheless, Tellabs introduced it in 2000 and customers realized that it "was not even close to being ready" when they put the product in their labs. (*Id.* ¶ 171.) CS-3, however, left Tellabs prior to the commencement of the purported Class Period. Plaintiffs fail to state how CS-3, who no longer works for Tellabs, has information about Jackman's knowledge during the purported Class Period. Without this information, the Court cannot distinguish whether the allegations about Jackman are "mere rumor and speculation or whether [they are] based on concrete information from . . . people who were in a position to know the truth of the allegations." *Adams v. Kinder-Morgan*, 340 F.3d at 1101. Plaintiffs have therefore not particularized their allegations with respect to Jackman.

6. Richard Notebaert

Notebaert served as Tellabs' Director and its CEO and President during the Class Period. Plaintiffs allege that Notebaert made many of the false and misleading statements complained of in this action. Plaintiffs have alleged that Notebaert knew or recklessly ignored that they were false and misleading because, as CEO, he was informed of the serious problems affecting Tellabs' business, products, and performance. They allege, as with some of the other executives, that Notebaert attended town hall meetings of Tellabs' employees, "had telephone calls every day and stayed on top of everything," had discussions with Senior Vice Presidents regarding weekly revenue calls and had his "hands on the pulse of everything." (R. 63-1, SAC ¶ 153.) They further allege that Notebaert knew the status of Tellabs' products, including whether or not they were selling. (*Id.* ¶ 154.) These allegations support that Notebaert was active in Tellabs' business as one would expect, but they do not establish scienter. *See Zishka v. American Pad & Paper Co.*, 72 Fed.Appx. 130, 131 (5th Cir.2003) (finding defendants' positions within the company insufficient to presume knowledge of the company's alleged false statements). Plaintiffs do not disclose any details regarding what Notebaert allegedly learned during these calls or meetings that support an inference of scienter.

Furthermore, the allegation that Notebaert attended a late April 2001 meeting where he explained that the SALIX technology was not current and was superseded by other technologies is consistent with Tellabs' April 18, 2001 public disclosure announcing termination of its SALIX product line. Given that Tellabs had disclosed this information *before* late April, this allegation does not even support an inference of negligence, much less recklessness.

Plaintiffs also allege that Notebaert attended a meeting in February 2001 with approximately 24 SALIX and Tellabs

employees regarding the SALIX product line. (R. 63-1, SAC ¶ 153.) Plaintiffs fail, however, to identify any details about the meeting or the information conveyed to Notebaert.

Plaintiffs also generally allege that "Notebaert knew the status of each product, how it was working, if the product was selling, and to whom from speaking with sales people." (*Id.* ¶ 154.) This general conclusion does not satisfy the scienter requirements under the PSLRA.

The SAC also includes allegations regarding Notebaert and channel stuffing. Plaintiffs allege that Notebaert worked directly with Tellabs' sales personnel to effect channel stuffing with respect to Tellabs' customer, SBC. Plaintiffs further allege that, according to CS-3, Notebaert knew about the channel stuffing activity relating to the TITAN 5500 and he "pushed and prodded the Company's sales personnel." (*Id.* ¶ 156.) These conclusory statements, however, are not supported with any details. Plaintiffs do not provide details of any specific actions taken by Notebaert to further the channel stuffing. They do not identify what channel stuffing activities he worked on. Such allegations are critical because the Court has concluded that there is nothing inherently wrong with several of Plaintiffs' channel stuffing allegations. It is also significant that CS-3 left Tellabs *prior* to the commencement of the purported Class Period. Without more specific allegations, and without a more reliable source, Plaintiffs have not sufficiently pled a strong inference that Notebaert knew of any actionable channel stuffing activities.

Plaintiffs conclusory allegations regarding Notebaert do not create a strong inference that he acted with the requisite state of mind under the PSLRA. Plaintiffs rely on group pleading allegations about Notebaert's position in the company and general conclusions concerning his knowledge of the allegedly fraudulent activities without providing particulars to reinforce their general conclusions. Such allegations fail to meet the mandates of the PSLRA.

VI. Section 20(a)—Control Person Liability

This Court previously dismissed Plaintiffs' Section 20(a) claim for failure to allege specific control as to Defendants Gruenwald, Kohler, Puller, and Souders, and for failure to allege an underlying securities violation. Defendants seek to dismiss Plaintiffs' claim for control person liability under Count II of the SAC on the same grounds.

A. Rule 9(b) Applies to Section 20(a) Claims

Initially, Plaintiffs suggest that this Court wrongly concluded that the heightened pleading requirements of Rule 9(b) apply to Section 20(a) control person allegations. (R. 78-1, Pls. Opp. to Mot. to Dismiss p. 37 n. 28.) Plaintiffs have cited several cases holding that Rule 9(b) does not apply to Section 20(a), but those opinions are not binding on this Court, and this Court is not persuaded by their reasoning. Section 20(a) claims are sounded in fraud, thus Plaintiffs must meet the heightened pleading requirements of Rule 9(b). *See In re Loewen Group Inc.*, No. Civ.A 98-6740, 2003 WL 22436233, *7 (E.D.Pa. July 16, 2003) ("Section 20(a) claims sound in fraud and therefore must comply with the pleading requirements of Federal Rule of Civil Procedure 9(b)"); *Wafra Leasing Corp. 1999-A-1 v. Prime Capital Corp.*, 204 F.Supp.2d 1120, 1126 (N.D.Ill.2002) (same); *Nanopierce Techs., Inc. v. Southridge Capital Mgmt. LLC*, No. 02 Civ. 0767 LBS, 2002 WL 31819207 at *9 (S.D.N.Y. Oct.10, 2002) (same).

B. Control Person Liability

Defendants again seek to dismiss the control person claim on the ground that Plaintiffs have failed to allege a primary securities fraud violation. In order to state a Section 20(a) claim, Plaintiff must allege the following: (1) a primary securities violation; (2) each of the Individual Defendants exercised general control over the operations of Tellabs; and (3) each of the Individual Defendants "possessed the power

or ability to control the specific transaction or activity upon which the primary violation was predicated, whether or not that power was exercised." *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 881 (7th Cir.1992). Because Plaintiffs have failed to plead a primary securities violation, Count II is dismissed.

Furthermore, Plaintiffs have failed to allege that Defendants Kohler or Pullen exercised the requisite level of control over either the Company or possessed the power or ability to control the alleged misrepresentations and projections.

1. Kohler

Plaintiffs have failed to allege sufficient facts to support the conclusion that Defendant Kohler was a control person. Plaintiffs allege that Kohler served as Tellabs' Senior Vice President of Global Business Operations (Global Manufacturing) from February 2000 to March 10, 2003, and as Tellabs' Vice President of Global Manufacturing from 1992 through 2000. (R. 63-1, SAC ¶ 19.) "Kohler was a sales-oriented person." (*Id.* ¶ 158.) Plaintiffs allege that as part of his sales position, Kohler attended meetings with senior level employees of certain Tellabs' customers. (*Id.* ¶ 159.) These allegations fail to support the assertion that Kohler had control over Tellabs or the power or ability to control the alleged misrepresentations at issue in this case. Plaintiffs do not allege that Kohler made any of the statements at issue. Nor do they specifically allege that he was aware of any such statements being made. Kohler did not sign any of the SEC filings at issue. His position as a corporate officer who reports to others, without more, is insufficient to allege Section 20(a) liability. *See generally Starr v. AHey, Inc.*, 2003 WL 21212596, *4 (N.D.Ill. May 23, 2003) ("[A] plaintiff may not premise control person liability solely upon status within the company.").

2. Pullen

With respect to Pullen, Plaintiffs allege that he served as Tellabs' Senior Vice President and General Manager of Optical Networking from August 2000 to February 2, 2002. (R. 63-1, SAC ¶ 21.) In that capacity, Plaintiffs allege that Pullen "had responsibility with respect to the TITAN series products at issue in this action." (*Id.*) They allege that Pullen was aware of TITAN 6500 production problems and that the product was failing evaluations. (*Id.* ¶ 50.) Plaintiffs further allege that Pullen made numerous visits to TITAN 6500 customers in connection with failed evaluation problems. (*Id.* ¶ 50.) They allege that Pullen knew that the TITAN 6500 was not ready for disbursement despite public statements to the contrary. (*Id.* ¶ 53.)

Plaintiffs allege that at the December 11, 2000 securities analysts conference, "ABN AMRO, Inc. reported Defendant Pullen's comment that the TITAN 5500 remains the workhorse of the group and is expected to see strong growth for the next 2-3 years." (*Id.* ¶ 77d.) They do not make any other specific allegations regarding Pullen and the TITAN 5500. The only other statement attributed to Pullen is one on June 5, 2001, in a press release, where Pullen noted "[o]ur TITAN 6500 system is the industry's only carrier-class transport system that uses the most innovative cell-based switching fabric with electrical and optical capabilities for converged services." (*Id.* ¶ 129.) Plaintiffs also allege that Pullen was aware of the TITAN 6500 production problems and that the product was failing evaluations, and that he made numerous visits to TITAN 6500 customers regarding such failed evaluation problems. (*Id.* ¶ 159.)

As with Kohler, Plaintiffs fail to specifically allege that Pullen signed any of the financial reports or SEC filings at issue. They fail to specifically allege facts supporting that Kohler had the ability to control the specific activities at

issue. Accordingly, Kohler is dismissed with prejudice from Count II.

VII. Insider Trading

Plaintiffs have sued Defendants Birck (Counts III, IV, and V) and Kohler (Count III) for insider trading pursuant to Section 20A of the Exchange Act. A private cause of action exists under Section 20A against persons who purchase or sell a security "while in possession of material, nonpublic information." Such an action may be brought by "any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased . . . or sold . . . securities of the same class." *United States v. O'Hagan*, 521 U.S. 642, 666, 117 S.Ct. 2199, 2214, 138 L.Ed.2d 724 (1997) (quoting 15 U.S.C. § 78t-1(a)); *see also Fujisawa Pharmaceutical Co., Ltd. v. Kapoor*, 115 F.3d 1332, 1337 (7th Cir.1997). Liability under Section 20A is predicated upon an independent violation of "this chapter or of any rules or regulations[s] thereunder." 15 U.S.C. § 78t-1(a). Section 20A claims are "derivative, requiring proof of a separate underlying violation of the Exchange Act." *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 541 (3d Cir.1999); *see also In re Foundry Networks, Inc. Sec. Litig.*, No. C 00-4823 MMC, 2003 WL 22077729, at *16 (N.D.Cal. Aug.29, 2003). In order to assert a claim for insider trading in violation of Section 20A, a plaintiff must show a predicate violation of the securities laws. Because Plaintiffs have failed to allege a securities fraud violation, Counts III, IV, and V are dismissed.

CONCLUSION

Defendants' motion to dismiss is granted. Plaintiffs have had three chances to plead their case against Tellabs and the Individual Defendants. In its *May 19, 2003 Opinion*, the Court provided Plaintiffs with a detailed analysis of the deficiencies in their complaint. The Court also granted Plain-

tiffs' request for an extension to file their SAC in order to give them more time to conduct their investigation into the allegations at issue. Plaintiffs, however, still have failed to cure these deficiencies, even though they have had more than sufficient time and guidance to do so.

Rule 15(a) provides that a court should freely grant a party leave to amend pleadings "when justice so requires." Fed.R.Civ.P. 15(a). A court, however, need not provide plaintiffs with that opportunity if it finds undue delay, bad faith or dilatory motive, repeated failure to cure deficiencies by amendments previously allowed, undue prejudice to the opposing party by virtue of allowance of the amendment, or futility. *See General Elec. Capital Corp. v. Lease Resolution Corp.*, 128 F.3d 1074, 1085 (7th Cir.1997). Here, Plaintiffs have had three opportunities to plead their case. They also had fair and detailed notice of their pleading deficiencies. Accordingly, the Court dismisses the SAC with prejudice.

APPENDIX C

UNITED STATES DISTRICT COURT
N.D. ILLINOIS
EASTERN DIVISION

No. 02 C 4356

THOMAS JOHNSON,

Plaintiff,

v.

TELLABS, INC., MICHAEL J. BIRCK, RICHARD C. NOTEBAERT, JOHN VAUGHN, ROBERT W. PULLEN, JOAN E. RYAN, BRIAN JACKMAN, J. THOMAS GRUENWALD, JOHN C. KOLHER, WILLIAM F. SOUDERS and CATHERINE KOZIK,

Defendants.

May 19, 2003

MEMORANDUM OPINION AND ORDER

ST. EVE, *District Judge.*

Plaintiffs allege that Defendants engaged in a scheme to deceive and defraud the investing public as to the true value of Tellabs, Inc.'s ("Tellabs") common stock. Plaintiffs contend that Defendants carried out this scheme, in part, by making misrepresentations about Tellabs' current financial condition and future prospects. According to Plaintiffs, these misrepresentations were false and misleading and resulted in the artificial inflation of Tellabs' stock price. Plaintiffs claim that they were injured when they purchased Tellabs' common stock at these artificially inflated prices.

Defendants seek to dismiss the Consolidated Amended Class Action Complaint (the "Complaint") for failure to state a claim upon which relief can be granted pursuant to Federal

Rule of Civil Procedure 12(b)(6), for failure to plead fraud with particularity pursuant to Federal Rule of Civil Procedure 9(b), and for failure to meet the pleading standards set forth in the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b) (the "PSLRA"). For the reasons set forth below, Defendants' motion is granted.

ALLEGATIONS

I. The Parties

This putative class action lawsuit is brought by various plaintiffs individually and on behalf of persons who purchased common stock of Defendant Tellabs between December 11, 2000 and June 19, 2001 (the "Class Period"). On September 27, 2002, the Court appointed Makor Issues & Rights ("Makor Issues") Lead Plaintiff pursuant to 15 U.S.C. § 78(u)-4. *See Johnson v. Tellabs, Inc.*, 214 F.R.D. 225 (N.D.Ill. 2002).

Tellabs is a Delaware corporation with its principal place of business in Lisle, Illinois. (R. 40-1, Compl.¶ 21.) Tellabs designs, manufactures and markets highly specialized optical network and broadband access equipment as well as other hardware for use in fiber-optic cable networks. (*Id.* ¶ 50.) It is a global supplier of networking solutions and services that support the Internet. The Tellabs' products that are relevant to this case are the TITAN 5500, the TITAN 6500 and the SALIX 7600. All of these products are complex transmission systems utilized with optical networking systems. The TITAN 5500 is a digital cross-connect product that is utilized by many of the major telecommunications companies. (*Id.* ¶ 51.) The TITAN 6500 is a multi-service transport switch. (*Id.* ¶ 53.) The SALIX 7600 is a software control suite that helps carriers increase revenue by building low cost networks that deliver innovative new services quickly. (*Id.* ¶ 62.)

Defendants Michael Brick, J. Thomas Gruenwald, Brian Jackman, John Kohler, Catherine Kozik, Richard Notebaert,

Robert Pullen, Joan Ryan and William Souders (collectively, the "Individual Defendants") are all officers and/or directors of Tellabs. Michael Birck was a director and served as chairman of Tellabs' board of directors beginning in 2000. (R. 40-1, Compl.¶ 22.) He also served as chief executive officer and president of Tellabs from 1975 through 2000. (*Id.*) J. Thomas Gruenwald served as a senior vice president and general manager of the broadband access group since 1999 and as a vice president of strategic resources from 1995 through 1999. (*Id.*) Brian Jackman was a director of Tellabs and served as president of global systems and technology. He also was president and an executive vice president of business operations from 1990 through 1998. (*Id.*) John Kohler was a senior vice president of global business operations beginning in 2000 and a vice president of global manufacturing from 1992 through 2000. (*Id.*)

Beginning in 2000, Catherine Kozik served as chief information officer and as a senior vice president of global information services. (R. 40-1, Compl.¶ 22.) Also that year, Richard Notebaert became a director and served as chief executive officer and president of Tellabs. (*Id.*) Robert Pullen was a senior vice president and general manager of optical networking starting in 2000. Pullen also served as a vice president of engineering and marketing in the digital systems division from 1997 through 2000. (*Id.*) Joan Ryan was an executive vice president and chief financial officer since 2000. (*Id.*) Finally, William Souders served as a director of Tellabs.[1] (*Id.*)

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[1] Plaintiffs initially included John Vaughn as a defendant in the case, but subsequently voluntarily dismissed him without prejudice. (*See* R. 23-1.)

II. Stock Sales

Plaintiffs allege that Birck, Gruenwald, Kohler, Kozik and Souders[2] sold stock during the purported Class Period at an artificially inflated price.[3] During this period of time, Plaintiffs claim that Birck sold 80,000 shares for $5,183,150; Gruenwald sold 1,500 shares for $93,281; Kohler sold 7,500 shares for $484,968; Kozik sold 3,220 shares for $187,766; and Souders sold 16,000 for $560,074. (R. 40-1, Comp.¶ 22.)

III. The Telecommunications Industry

Plaintiffs allege that the telecommunications industry suffered a significant decline in demand for its products in early 2000. (*Id.* ¶¶ 3, 47.) In addition, Plaintiffs claim that the Internet sector substantially contracted, which "severely constrict[ed] continued access to capital and demand for products to maintain and further develop what had been a rapidly expanding and growing Internet and telecommunications infrastructure." (*Id.* ¶ 47.) According to Plaintiffs, many of Tellabs' competitors suffered a dramatic decline in earnings. (*Id.* ¶ 48.) Plaintiffs maintain that Defendants disguised the impact this decline had on Tellabs and, instead, falsely contended that Tellabs was not affected by the industry slow-down.

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[2] Although the Complaint alleges that Souders sold stock on February 20, 2001, Plaintiffs have acknowledge that the correct date of this sale is April 20, 2001.

[3] The Complaint also refers to trades by "Defendant Suwinski" and "Defendant Gugliemi." (R. 40-1, Compl.¶¶ 63, 79.) Neither of these people are named as defendants in the Complaint. Moreover, the Complaint does not contain any additional allegations against these individuals, including what position, if any, they held at Tellabs. Plaintiffs do not allege that Suwinski or Gugliemi made any misrepresentations or projections. Accordingly, these allegations do not state a claim against Suwinski or Gugliemi.

IV. Allegedly False Statements by Tellabs

Plaintiffs claim that during the purported Class Period, Defendants made a series of false statements and omissions that resulted in the artificial inflation of Tellabs' stock price. These purported false statements and omissions related to Tellabs' financial condition, its earnings and operations and its future prospects. Specifically, Plaintiffs maintain that Defendants falsely reported Tellabs' financial condition for fourth quarter of 2000, and provided false "guidance" for 2001. According to Plaintiffs, Defendants also communicated regularly and directly with securities analysts and provided them with these misrepresentations so that the security analysts would unknowingly falsely promote Tellabs, resulting in an artificially inflated price of Tellabs' common stock.

A. December 2000

On December 11, 2000—the start of the purported Class Period—Tellabs issued a press release announcing a strategy to deliver an all optical network. The press release noted, "Tellabs is making all-optical networking a reality . . . . We have the strategy and the products that will enable service providers to deliver and manage all-optical services on demand." (R. 40-1, Compl.¶ 52.) On that same day, Tellabs also announced a multi-year $100 million sales agreement with Sprint for the Titan 6500 multi-service transport switch. The release reported that "[t]he TITAN 6500 helps carriers manage their SONET and SDH-based broadband networks today and protects their investment as we migrate to packet networks tomorrow. The TITAN 6500 system is available now." (*Id.* ¶ 53.)

The next day, securities analysts issued positive research reports on Tellabs. UBS Warburg noted, "Tellabs maintained its guidance for 4Q 2000 and all of 2001. In doing so, the company indicated that the demand for its Titan 5500 product line remain [sic] solid in 4Q and there is visibility for at least

two years (if not more) of ongoing good growth for the product." (*Id.* ¶ 55.) It also estimated thirty-percent growth in sales for 2001. ABN AMRO reported that "the TITAN 5500 remains the workhorse of the group and is expected to see strong growth for the next 2-3 years." (*Id.*) Baird & Co. reported that Tellabs "reiterated its confidence in the telecom-spending environment" and "reconfirmed consensus growth forecasts for fourth quarter 2000 and 2001." (*Id.*)

B. January 23, 2001 Press Release

On January 23, 2001, Tellabs reported fourth quarter net income of $232 million. (R. 40-1, Compl.¶ 58.) Its press release noted that the "strength in Tellabs' core business drove record sales and earnings in the fourth quarter of 2000. Fourth-quarter 2000 sales totaled $1,018 million, up 42% from $716 million in 1999." The press release also stated that fourth quarter net income was up 41% from 1999. (*Id.*) Notebaert explained, "[t]o keep up with robust growth in communications traffic customers are buying more and more Tellabs equipment—fueling our records [sic] results and our first $1 billion quarter." (*Id.*)

During a teleconference with securities analysts that day, Notebaert commented on the TITAN 6500. Specifically, he said that "[o]n the 6500, demand for that product is exceeding our expectations . . . . We had spent . . . a large amount of time working on our ability to create or manufacture enough product to meet customer demand. Demand is just . . . huge for this product." (R. 40-1, Compl.¶ 59.) In an interview with Eric Schatzker from the Bloomberg News, Notebaert also commented: "I'm a little surprised at the performance of our stock the last few weeks, because last quarter, this quarter, we've been solid and we feel very, very good about the robust growth we're experiencing." (*Id.* ¶ 60.)

Following the press release and teleconference, numerous securities analysts issued positive research reports for Tellabs.

On January 24, 2001, for example, Morgan Stanley reiterated its "outperform" rating and noted that "sales of the TITAN products continued to fuel growth." (*Id.* ¶ 61.)

C. January 30, 2001 Press Release

Tellabs issued another press release on January 30, 2001, announcing "a new suite of softswitches, the SALIX 7600 softswitch control suite." (R. 40-1, Compl.¶ 62.) The press release noted, "[t]he SALIX 7600 brings together voice and data technologies to create a set of telepacket service applications that can help carriers grow profitably." (*Id.*) It also stated, "[w]ith the new SALIX 7600 suite, Tellabs has redefined the softswitch market and can now offer integrated, comprehensive solutions to all carriers." (*Id.*)

D. March 2001

On March 7, 2001, Tellabs issued a press release announcing that it was lowering its revenue and earnings per share expectations for the first quarter 2001. It noted, "Tellabs projects first quarter sales in the range of $830 million to $865 million . . . . The company projects earnings per share in the range of 35 cents to 38 cents, compared with prior guidance of 39 cents per share." (R. 40-1, Compl.¶ 67.) It also reported that Tellabs could not recognize revenue from TITAN 6500 shipments in the first quarter but expected to do so in the second quarter of 2001. (*Id.*) "Growth in Tellabs' core optical networking business remains strong." (*Id.*) Notebaert went on to project, "[g]iven the strong acceptance of the new TITAN 6500, we continue to target 30 percent growth in revenue and earnings for the year . . . . Demand for our new products is strong, and I am confident we have the right set of solutions to help our customers build tomorrow's converged networks." (*Id.*)

During a March 8, 2001 teleconference with securities analysts, Notebaert reiterated that "demand for our core optical products, or our core networking products remains

strong . . . . We are as confident as ever—that may be an understatement—about the 6500 . . . . To put this into a bit more perspective, we still expect revenue and EPS growth for the quarter to exceed 30% . . . . Tellabs will meet the adjusted revenue and earnings targets." (R. 40-1, Compl.¶ 68.) Notebaert also stated that Tellabs had not received "any indication from any of our major clients, major customers, of a downturn in the segment we're in . . . ." (*Id.*) Defendant Jackman added, "[t]here's nothing in the revenue recognition issue that should be construed to imply that the testing and the customer's acceptance of these systems are having difficulty." (*Id.*) That day, various securities analysts issued favorable reports and maintained their buy ratings for Tellabs' stock. (*Id.* ¶ 69.)

On March 29, 2001, Tellabs issued its 10-K for 2000. The "Highlights" section of the financial statement noted: "The Company achieved record levels in sales ($3,387.4), net earnings ($730.8 million) and earnings per share ($1.75)—putting it on track to meet its objective of $6 billion in annual revenues by the year 2003." (R. 40-1, Compl.¶ 71.) It also stated that "[t]he growth in optical networking product sales was a result of continued strong demand for the Company's TITAN 5500/5500S and TITAN 532L digital cross connect systems." (*Id.*) Tellabs reported that it expected "continued strong sales growth in 2001." (*Id.*)

E. April 6, 2001

On April 6, 2001, Tellabs issued another press release that lowered its first quarter guidance. The press release stated, "[t]he revised guidance stems from reduced and deferred spending by major communications carriers late in the quarter." (R. 40-1, Compl.¶ 72.)

That same day, Notebaert was quoted as saying, "[t]he good news is, orders weren't canceled, they were pushed out into the next quarter." (*Id.* ¶ 73.) In a conference call with

analysts that same day, Notebaert stated that "the 6500 is showing strength . . . we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong." (*Id.* ¶ 74.)

F. April 18, 2001[4]

On April 18, 2001, Tellabs issued a press release announcing its first quarter financials for the period ending March 31, 2001 and reducing its revenue projections for 2001. Notebaert stated, "I am as confident as ever in Tellabs' long-term prospects and our ability to deliver strong revenue and earnings growth in the future." (R. 40-1, Compl.¶ 77.)

G. June 2001

On June 19, 2001, which is the close of the purported Class Period, Tellabs issued a press release revising its second quarter guidance and reducing its revenues by approximately $300 million to $500 million. (*Id.* ¶ 85.) Tellabs common stock fell from a high of $23.01 per share on June 19, 2001 to a low of $15.87 per share on June 20, 2001. (*Id.* ¶ 87.) The June 20, 2001 price reflected a "decline of more than 75% from the Class Period high of $67.125." (*Id.*)

V. Tellabs' Accounting Practices

Plaintiffs allege that Defendants knowingly and recklessly employed improper accounting practices that falsely inflated Tellabs' balance sheet and falsely reported income and expenses in the interim quarters and fiscal year during the purported Class Period, in violation of Generally Accepted Accounting Principles ("GAAP"). (R. 40-1, Compl.¶ 93.)

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[4] The Complaint also contains allegations regarding a May 9, 2001 article entitled "Tellabs on Deck" that quotes John Vaughn. That article, however, was released on May 9, *2000*—not 2001. This was published before the purported Class Period. Accordingly, it cannot support a cause of action.

They further contend that Defendants engaged in "channel stuffing" activities to conceal true sales and that Tellabs offered its customers special incentives and the unlimited right of return in order to improperly overstate Tellabs' revenues. (*Id.* ¶ 98.)

ANALYSIS

The three count Complaint in this case is premised on securities fraud arising out of the purchase of Tellabs' common stock. In count one, Plaintiffs allege that Defendants violated Section 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5. Count two alleges that the Individual Defendants violated Section 20(a) of the Exchange Act. Count three alleges that Birck, Kozik, Kohler, Souders and Gruenwald violated Section 20A of the Exchange Act by insider trading. Defendants move to dismiss the Complaint in its entirety for failure to state a claim pursuant to Federal Rule of Civil Procedure 12(b)(6), for failure to plead fraud with particularity pursuant to Federal Rule of Civil Procedure 9(b), and for failure to meet the pleading standards set forth in the PSLRA.

I. Legal Standard

The purpose of a motion to dismiss pursuant to Rule 12(b)(6) is to test the legal sufficiency of a complaint, not the merits of the case. *See Triad Assocs., Inc. v. Chicago Hous. Auth.*, 892 F.2d 583, 586 (7th Cir.1989). When considering a motion to dismiss, the Court considers "whether relief is possible under [any] set of facts that could be established consistent with [the] allegations." *Bartholet v. Reishauer A.G. (Zurich)*, 953 F.2d 1073, 1078 (7th Cir.1992). The Court views all the facts alleged in the Complaint, as well as any reasonable inferences drawn from those facts, in the light most favorable to Plaintiff. *See Stachon v. United Consumers Club, Inc.*, 229 F.3d 673, 675 (7th Cir.2000).

Dismissal of a complaint is appropriate only where it appears beyond doubt that under no set of facts would the plaintiff's allegations entitle him to relief. *Henderson v. Sheahan,* 196 F.3d 839, 846 (7th Cir.1999); *Kennedy v. National Juvenile Det. Ass'n,* 187 F.3d 690, 695 (7th Cir.1999). A plaintiff that solely attaches bare legal conclusions to narrated facts that fail to outline the bases of his claims does not satisfy federal pleading requirements. *Collins v. Snyder,* No. 02 C 4493, 2002 WL 31749173, at *1 (N.D.Ill.Dec.2, 2002).

II. Securities Fraud Pleading Requirements

Plaintiffs rely on two general categories of alleged misrepresentations to support their securities fraud claim: (1) Defendants' purportedly false revenue reports for the fourth quarter of 2000, and (2) Defendants' allegedly fraudulent revenue projections. Plaintiffs claim that both categories of misrepresentations artificially inflated the price of Tellabs' stock during the purported Class Period.

A. Rule 9(b) and the PSLRA

Plaintiffs' allegations are sounded in fraud. Therefore, the heightened pleading requirements of Federal Rule of Civil Procedure 9(b) apply. Rule 9(b) mandates that a plaintiff plead "the circumstances constituting fraud . . . with particularity." *In re HealthCare Compare Corp. Sec. Litig.,* 75 F.3d 276, 281 (7th Cir.1996). As the Seventh Circuit has explained, "this means the who, what, when, where, and how: the first paragraph of any newspaper story." *DiLeo v. Ernst & Young,* 901 F.2d 624, 627 (7th Cir.1990). This particularity requirement is necessary to ensure that the plaintiff "conduct[s] a precomplaint investigation in sufficient depth to assure that the charge of fraud is responsible and supported, rather than defamatory and extortionate." *Ackerman v. Northwestern Mut. Life Ins. Co.,* 172 F.3d 467, 469 (7th Cir.1999).

In addition to Rule 9(b), the strict pleading mandates of the PSLRA apply to Plaintiffs' Complaint. In enacting the PSLRA, Congress raised the pleading standards for litigants bringing private securities fraud claims. *See In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 973 (9th Cir.1999). In order to meet the PSLRA's dictates for a securities fraud claim, "the complaint shall specify each statement alleged to have been misleading, the reasons or reasons why the statement is misleading, and if an allegation regarding the state or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1).[5]

B. Pleading on Information and Belief

Plaintiffs admit that they base many of their allegations on "information and belief." They allege that the information as to Defendants is based upon an investigation by Plaintiffs' counsel that included interviews of former Tellabs' employees and customers and a review and analysis of public filings, news articles, press releases and analysts reports by or relating to Tellabs. Defendants argue that because the allegations are based on information and belief, Plaintiffs must follow the test articulated by the Second Circuit in *Novak v. Kasaks*, 216 F.3d 300, 313-14 (2d Cir.2000). Plaintiffs contend that Defendants advocate a *per se* rule that a plaintiff must identify the names confidential sources in a complaint that is pled on information and belief.[6] A reading of *Novak*, however, shows that the Second Circuit rejected a *per se* rule. *See id.* at 314 ("we find no requirement in

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[5] The PSLRA also raised a plaintiff's pleading requirement for scienter, *see* 15 U.S.C. § 78u-4(b)(2), as the Court discusses *infra* in Section III.B.

[6] A *per se* requirement is inappropriate because it would have a chilling effect on employees who provide information about "corporate malfeasance." *In re Cabletron Sys., Inc.*, 311 F.3d 11, 30 (1st Cir.2002).

existing law that, in the ordinary course, complaints in securities fraud cases must name confidential sources").

Instead, the Second Circuit concluded that "where plaintiffs rely on confidential sources but also on other facts, they need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants' statements were false." *Novak*, 216 F.3d at 314. The *Novak* court noted that "a complaint can meet the new pleading requirement imposed by paragraph (b)(1) by providing documentary evidence and/or a sufficient general description of the personal sources of the plaintiffs' beliefs." *Id.* This Court agrees with the Second Circuit's approach in *Novak*. Accordingly, the Court will analyze Plaintiffs' allegations consistent with *Novak* and determine the sufficiency of the facts that purport to support the allegations in the Complaint.

C. Group Pleading

Plaintiffs rely in part on group pleading and group-published documents such as Tellabs' 10-K in order to allege Defendants' misrepresentations and omissions. They allege, for example, that "[i]t is appropriate to treat the Individual Defendants as a group for pleading purposes and to presume that the materially false, misleading and incomplete information conveyed in the Company's public filings, press releases and other publications as alleged here are the collective actions of the narrowly defined group of defendants identified above." (R. 40-1, Compl.¶ 25.) They further allege that each of the Individual Defendants was an officer or director of Tellabs and, "because of their positions of control and authority as officers and/or directors of the Company, were able to and did control the content of the various SEC filings, press releases and other public statements pertaining to the Company during the Class Period." (*Id.* ¶ 28.)

The "group pleading" doctrine creates the presumption that senior executives of a corporation may be held liable for misrepresentations or omissions contained in public statements that are attributable to or issued by a corporation. It "allows plaintiffs to rely on the presumption that certain statements of a company, such as financial reports, prospectuses, registration statements, and press releases, are the collective work of those high-level individuals with direct involvement in the everyday business of the company." *Sutton v. Bernard,* No. 00 C 6676, 2001 WL 897593, at *5 n. 5 (N.D.Ill. Aug.9, 2001).

The group pleading doctrine, however, predates the enactment of the PSLRA. The Seventh Circuit has yet to address whether the doctrine survives the PSLRA, and the courts in this District are split. *Compare Danis v. USN Communications, Inc.*, 73 F.Supp.2d 923, 939 n. 9 (N.D. Ill.1999) (allowing plaintiffs to rely on the group pleading doctrine), with *Chu v. Sabratek Corp.*, 100 F.Supp.2d 827, 835-37 (N.D.Ill.2000) (disagreeing with *Danis* and concluding that allegations based on an individual's position within the company are insufficient under the PSLRA).

It is not entirely clear what effect the PSLRA has on the group pleading doctrine with respect to holding individual defendants liable for statements by the company.[7] Even if the group pleading doctrine survives the PSLRA in some form, however, it is apparent that the statute requires Plaintiffs to allege facts that support an inference that the statement is attributable to individual defendants. The PSLRA obligates a plaintiff to allege specific facts as to each of the defendant's misrepresentations or omissions. 15 U.S.C. § 78u-4(b)(1). A plaintiff is therefore required at least to include allegations in

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[7] It is entirely clear, however, that the PSLRA abolishes the use of the group pleading doctrine to allege defendant's scienter. *See infra*, Section III.B.

the complaint relating to an individual defendant's duties or legal obligations that create a presumption that the company's statement was somehow caused by or attributable to an individual defendant. Simply alleging an individual defendant's title is not enough. Unfortunately for Plaintiffs, that is all they have done. Plaintiffs have not adequately alleged that any individual defendant is liable for Tellabs' statements, even if some form of the group pleading doctrine is still viable. Accordingly, the Court will not consider Tellabs' alleged misrepresentations or omissions in determining whether Plaintiffs have stated a claim against the Individual Defendants.

III. Count One—Section 10(b) Violations

In order to state a claim under Section 10(b), Plaintiffs must allege that Defendants: (1) made a false statement or omission; (2) of a material fact;[8] (3) with scienter; (4) in connection with the purchase or sale of securities; (5) upon which Plaintiffs justifiably relied; and (6) the reliance proximately caused Plaintiffs' damages. *In re HealthCare Compare Corp.*, 75 F.3d at 280. Defendants contend that Plaintiffs have failed to satisfy these pleading requirements with respect to any statement by any Defendant.

A. False Statement or Omission

1. Allegations regarding Ryan and Pullen

Plaintiffs cannot sustain a cause of action against Pullen or Ryan in count one because the Complaint does not allege that any statements, much less any misrepresentations or omissions, are attributable to Ryan and nothing that is even close

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[8] A statement is material if "there is a substantial likelihood that disclosure of the information would have been viewed by the reasonable investor to have significantly altered the total mix of information." *Searls v. Glasser*, 64 F.3d 1061, 1066 (7th Cir.1995).

to a misrepresentation or omission by Pullen.[9] The only allegations particularized to Ryan or Pullen relate to the office that they held at Tellabs. This is not enough.

2. Allegations regarding Birck, Gruenwald, Kohler, Souders and Kosik

Similarly, the Complaint does not contain any facts particularized to the Defendants that sold stock—Birck, Gruenwald, Kohler, Souders and Kozik—to support their role in the misrepresentations or omissions. The Court is again left only with the titles of these individuals. Without more, Plaintiffs have not properly alleged that Tellabs' misrepresentations or omissions are attributable to these Defendants. The group pleading allegations that Plaintiffs use to include these Defendants in count one are insufficient to withstand the mandates of the PSLRA. Further, the Plaintiffs' repeated references to "Defendants" or "Individual Defendants" do not satisfy the PSLRA's requirements of pleading with specificity as to each Defendant. Accordingly, count one is dismissed with respect to Defendants Pullen, Ryan, Birck, Gruenwald, Kohler, Souders and Kozik.

3. Allegations regarding the Statement by Jackman

Plaintiffs only attribute one allegedly false statement to Jackman. (R. 40-1, Compl.¶ 68.) In response to a question regarding why revenues were not recognized on the TITAN 6500, Jackman responded: "There's nothing in the revenue recognition issue that should be construed to imply that the testing and the customer's acceptance of these systems are having difficulty." (R. 40-1, Compl.¶ 68.) Plaintiffs fail to detail what is false or misleading about this statement.

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[9] The only statement from the Complaint that is attributable to Pullen is included in the December 11, 2000 press release. That release quotes Pullen as saying, "Tellabs is making all-optical networking a reality." (R. 40-1, Compl.¶ 52.) There is nothing in the Complaint, however, that suggests that this statement is a misrepresentation.

Although Plaintiffs allege that the "Defendants" knew or recklessly disregarded that the production of the TITAN 6500 was far behind schedule and inferior to competitors' products, this allegation does not affect the veracity of Jackman's statement. Accordingly, Jackman's statement is not actionable under the allegations in the Complaint.

4. Allegations regarding Statements by Tellabs and Notebaert[10]

Plaintiffs base their Section 10(b) allegations against Tellabs and Notebaert primarily on two types of statements: (a) statements regarding Tellabs' fourth quarter 2000 financial results and (b) projections pertaining to Tellabs' future financial performance.

a. Fourth Quarter 2000 Financial Results

Plaintiffs allege that Defendants' statements regarding Tellabs' fourth quarter 2000 financial results were false and misleading because Tellabs had inflated its revenue figures for that quarter. Defendants argue that Plaintiffs have failed to plead sufficient facts to support their claims that Tellabs wrongfully inflated its revenues during the fourth quarter of 2000. Plaintiffs counter that they have pled the following activities which rendered Defendants' statements regarding Tellabs' fourth quarter false and misleading: (1) Defendants engaged in "channel stuffing" by (a) over-inventorying customers such as Telcobuy.com and SBC with products that the companies did not need to conceal the decline in demand for the TITAN 5500, (b) offering discounts and other incentives to customers and Value Added Resellers ("VARs") in order to increase fourth quarter 2000 sales to the detriment of first quarter 2001, and (c) entering into numerous con-

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[10] Unlike its treatment of the other Individual Defendants, the Complaint does detail many statements by Notebaert. (*See e.g. id.* ¶¶ 58, 59, 60, 68, 73, 74, 76, 81 & 88.)

signment transactions for products they knew, or recklessly disregarded, would not be needed by customers;[11] and (2) Defendants failed to take the required write down for excess and obsolete inventory which had accumulated since mid-2000. Plaintiffs argue that they have alleged particularized facts to support each of these activities that render Defendants' statements false and misleading.

(1) Channel Stuffing

"Channel stuffing" is the inducement of customers to substantially increase their purchases before they would otherwise buy products from the company in the normal course. *Greebel v. FTP Software*, 194 F.3d 185, 202 (1st Cir.2002). It results in the shifting of earnings into earlier quarters, which likely harms earnings in later quarters. *Id.* Plaintiffs allege on information and belief that Tellabs engaged in three different types of "channel stuffing."

(a) Over-Inventorying

Plaintiffs maintain that Tellabs "aggressively and improperly over-supplie[ed] customers with products by 'stuffing' its distribution channels with products that distributors and resellers could not sell. They contend that Defendants knew or recklessly disregarded that Tellabs' customers were over inventoried with the TITAN 5500 such that they would be decreasing their orders in the future, thereby causing Tellabs to experience future declines in sales." (R. 40-1, Compl. ¶ 64.) Plaintiffs contend that these "channel stuffing" activities artificially stimulated revenue in the short term for fourth quarter 2000.

Although the Complaint contains numerous conclusory allegations regarding Defendants' "channel stuffing" activi-

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[11] Although Defendants contend that all of these categories are not "channel stuffing" activities, but rather separate activities, in viewing the Complaint in the light most favorable to Plaintiffs, the Court disagrees.

ties, it includes only one "over inventorying" example to support those conclusions. Specifically, Plaintiffs allege that Tellabs engaged in "channel stuffing" in late 2000 in connection with sales to SBC Communications ("SBC") through Telcobuy.com by "over-inventorying Telcobuy.com during the fourth-quarter." (*Id.* ¶ 64.) Plaintiffs allege that Defendants over-inventoried customers such as Telcobuy.com and SBC with products that these companies did not need. (*Id.* ¶ 64.) Plaintiffs allege that "[a]s a result of the decline in demand, Telcobuy.com could not sell the products to SBC and thereafter requested to return the products to Tellabs in the beginning of 2001." (*Id.*)

Plaintiffs do not allege these facts with sufficient particularity. Specifically, the Complaint does not identify the particular terms of the "channel stuffing" with Telcobuy.com or any other customers, the individuals involved in the practice, or the documents exchanged in connection with it. Plaintiffs rely almost exclusively on general conclusions to support their proposition that Defendants knew or recklessly disregarded that Telcobuy.com could not sell Tellabs products to SBC after the over-inventorying. Plaintiffs' allegation that Telcobuy.com requested to return the products to Tellabs—rather than relying on an agreement to return them—in the beginning of 2001 undermines their allegations that an agreement was in place to engage in "channel stuffing."

Plaintiffs also allege that Tellabs' product returns were extremely heavy in January and February 2001, causing Tellabs to lease two additional storage facilities. (R. 40-1, Compl.¶ 101.) Plaintiffs allege that Bell Atlantic, Lexcom and Telcobuy.com were three customers that were returning products.[12] Plaintiffs, however, fail to support this claim with

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[12] Plaintiffs also allege that the returns were in the "millions" of dollars (R. 40-1, Compl.¶ 101.) Given that Tellabs' fourth quarter 2000 sales were more than a billion dollars, Plaintiffs' allegations of the dollar

any facts supporting that Defendants sold products in the fourth quarter of 2000 knowing that they would be returned by Bell Atlantic or Lexcom in 2001.[13] Without more, Plaintiffs have failed to allege that the statements regarding fourth quarter performance were misleading when made. Absent more, Plaintiffs are doing nothing more than playing Monday morning quarterbacks. Plaintiffs have not done enough to satisfy the *Novak* standard of sufficiency of pleading on information and belief.

(b) Incentives

Plaintiffs also allege that Tellabs' employees were instructed to offer discounts and other incentives to customers and VARs in order to increase Tellabs' sales for the fourth quarter of 2000. (*Id.* ¶¶ 64, 98.) To induce customers to purchase additional products, Plaintiffs allege that Tellabs offered "bundle opportunities" through payment discounts, offered substantial discounts in amounts of 10 to 20% and offered extensive credit terms. (*Id.*) These incentive activities, according to Plaintiffs, enabled Tellabs to improperly recognize revenue and falsely portray Tellabs' fourth quarter financials.

In the business world, there certainly is nothing inherently wrong with offering incentives to customers to purchase products. Plaintiffs allege that customers such as Sprint and SBC were convinced to "take products" because of these

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amount of the returns are not specific enough for the Court to determine whether the "channel stuffing" related to product returns meet the materiality pleading standard.

[13] The Court recognizes that "channel stuffing" may have occurred regardless of the returns, because Tellabs customers may have been buying in the fourth quarter 2000 what they otherwise would have purchased in the first quarter 2001. Plaintiffs have not, however, provided any details to support this "channel stuffing" theory relating to these transactions.

incentives. Plaintiffs fail, however, to allege any facts supporting that such incentives were improper. For example, they do not provide specific examples of such practices or explain particular terms of such incentives. Plaintiffs must particularize their facts in order to proceed.

(c) Consignment

Plaintiffs also argue that they meet the pleading requirements of the PSLRA for the allegedly false statements regarding Tellabs' fourth quarter 2000 revenues through their allegations of consignment. Plaintiffs allege that Tellabs falsely inflated its fourth quarter revenues through a serious of consignment transactions for products which Defendants knew the customers would not need. (R. 40-1, Compl.¶ 64, 98.) Plaintiffs also allege this specific example:

> For example, after Tellabs booked a consignment transaction entered into with the VAR Lexcom as a sale, it shipped TITAN 5500 equipment in the beginning of 2001. Because Tellabs did not have a commitment from SBC to purchase all of the equipment, and SBC didn't need all of the equipment, Lexcom returned approximately $20 million worth of unused unneeded products in the second quarter of 2001.

(*Id.*)

Plaintiffs argue that Defendants should not have recognized the revenue from these sales during the fourth quarter of 2000 because they were consignment sales, and that Defendants violated GAAP by doing so. Although Plaintiffs have come close to particularizing this allegation, they fail to include the terms of the consignment.

(2) Obsolete Inventory

Finally, Plaintiffs allege that the statements regarding Tellabs' fourth quarter 2000 financial results were false and misleading when made because "defendants had improperly

failed to take a required write-down for excess and obsolete inventory which had been accumulating steadily since mid-year 2000." (R. 40-1, Compl. ¶ 64.) Plaintiffs claim that this resulted in Tellabs artificially inflating the value of its assets and stockholders equity. (*Id.*)

In similar situations, the Seventh Circuit has found that these allegations do not amount to fraud. In *DiLeo*, the Seventh Circuit affirmed a dismissal of a complaint where the plaintiffs sought to recover for tardy write-offs of bad loans. 901 F.2d at 627. The Seventh Circuit found that the complaint was deficient because it did not provide "a single concrete example" of how the write-offs were fraudulent. *Id.* The court went on to state, "[i]f all that is involved is a dispute about the timing of the writeoff, based on estimates of the probability that a particular debtor will pay, *we do not have fraud*; we may not even have negligence." *Id.* (emphasis added). In *Grassi v. Information Resources, Inc.*, 63 F.3d 596 (7th Cir.1995) the Seventh Circuit extended this principle outside of the loan context, to investments overall. *Id.* at 600 ("Plaintiffs essentially claim that IRI should have written off its bad investment sooner—but this is not fraud.").

Based on these cases, a plaintiff must allege more than delinquent write-offs. Instead, a complaint must specifically state how the delinquent write-offs somehow went beyond a bad business decision or negligence, and instead actually constituted fraud. Accordingly, Plaintiffs' write-down allegations fail to support a claim for fraud. The Complaint does not state how the failure to take the write-downs was fraudulent. It does not state the amount of the write-downs, what the obsolete inventory was, or why the write-downs were required to be taken then. Accordingly, Plaintiffs' write-off allegations do not support a cause of action against Defendants. Taking Plaintiffs' allegations of "channel stuffing" and write-off failures as a whole, they have not sufficiently pled a cause of action under the PSLRA.

b. Other Statements

Many of the other statements by Tellabs and Notebaert that Plaintiffs allege are false cannot support a cause of action in count one. In some instances, Plaintiffs have not alleged what is false about the statements. In other cases, the statements are not actionable because they are merely puffery.

(1) No allegations of falsity

Plaintiffs have alleged that other statements made by Defendants were false and misleading, including statements in the following press releases: December 11, 2000, May 31, 2001 and June 5, 2001. Defendants correctly note, however, that Plaintiffs fail to allege what, if anything, was false or misleading in Tellabs' December 11, 2000 press release regarding its optical networking strategy or its May 31, 2001 press release announcing a $262 million restructuring charge. Furthermore, the Complaint does not contain facts supporting the falsity of Tellabs' June 5, 2001 announcement of the introduction of a new software system for the TITAN 6500. As such, these statements are not actionable.

(2) Puffery

"Courts consistently hold that mere puffery and glowing representations of expected boom are not enough to state claims" under the Exchange Act. *Donovan v. ABC-NACO Inc.*, No. 02 C 1951, 2002 WL 1553259, at *7 (N.D.Ill. July 15, 2002) (citations and quotations omitted); *see also Anderson v. Abbott Labs.*, 140 F.Supp.2d 894, 904 (N.D.Ill.), *aff'd sub nom. Gallagher v. Abbott Labs.*, 269 F.3d 806 (7th Cir.2001). The majority of Plaintiffs' allegations regarding the progress of the TITAN 6500 and the TITAN 6700 are merely "puffery." For example, the January 23, 2001 press release noted that "[w]ith [the TITAN 6700], scheduled for second-quarter field trials and fourth-quarter availability, Tellabs completes a bandwidth management portfolio that scales from a single call to an entire wavelength of light."

That same day, Defendant Notebaert stated: "On the 6500, demand for that product is exceeding our expectations . . . ." Notebaert also stated: "We feel very, very good about the robust growth we're experiencing." Later, on March 8, 2001, Notebaert said, "[w]e are as confident as ever—that may be an understatement—about the 6500." These statements are nothing more than puffery and cannot be the basis of a cause of action in count one.

c. Projections

Plaintiffs also allege that Defendants violated Section 10(b) of the Exchange Act through multiple projections or forward looking statements about Tellabs' financial future. The Seventh Circuit has noted that "cases involving forward-looking statements are unique." *In re HealthCare Compare Corp.*, 75 F.3d at 281. "[A]n inability to foresee the future does not constitute fraud, because '[t]he securities laws approach matters from an *ex ante* perspective.'" *Eckstein v. Balcor Film Investors*, 8 F.3d 1121, 1132 (7th Cir.1993). In order for projections to be actionable, Plaintiffs must allege that Defendants made them with "the knowledge that they are incorrect or are otherwise without reasonable basis." *Katz v. Household Int'l., Inc.*, 91 F.3d 1036, 1039 (7th Cir.1996). "Projections which turn out to be inaccurate are not fraudulent simply because subsequent events reveal that a different projection would have been more reasonable." *In re HealthCare Compare*, 75 F.3d at 281. "[A]s long as those statements had a reasonable basis when made, they do not constitute fraud." *Searls v. Glasser*, 64 F.3d 1061, 1066 (7th Cir.1995) (citing *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 513 (7th Cir.1989)).

Defendants argue that the Court must dismiss Plaintiffs' claims regarding Tellabs' revenue projections because the projections are protected by the PSLRA's safe harbor, and because Plaintiffs have failed to allege that they were unreasonable when made. Because the Court agrees that the

projections are protected by the PSLRA's safe harbor and thus not actionable, the Court need not address the allegations pertaining to the reasonableness of these projections when made.

(1) The Allegations

Plaintiffs identify a series of revenue projections made by Tellabs in its press releases, teleconferences with analysts and its 2000 10-K. Each of these projections pertains to Tellabs' financial performance for the year 2001. (*See* R. 40-1, Compl. ¶¶ 55-56, 60-61, 65, 67-69, 71, 77.)

These projections include a December 12, 2000 call with analysts where Tellabs provided revenue guidance for 2001 and estimated 30% sales growth. (R. 40-1, Compl.¶ 54-55.) They also include a press release and conference call with securities analysts on January 23, 2001 where Tellabs "reassured investors" as to the Company's 2001 projections. (*Id.* ¶ 58.) During that same day in an interview with Eric Schatzker from the Bloomberg News, Notebaert stated "We feel very, very good about the robust growth we're experiencing." (*Id.* ¶ 60.) Furthermore, Plaintiffs allege that on March 7, 2001, Tellabs updated its guidance for the first quarter reducing its projections of first quarter sales to the range of $830 to $865 million. (*Id.* ¶ 68.) Notebaert then stated, "[w]e still expect revenue and EPS growth for the quarter to exceed 30%. Tellabs will meet the adjusted revenue and earnings targets." Tellabs' 10-K, filed on March 29, 2001, contained similar statements. (*See id.* ¶¶ 71-72.)

(2) The PSLRA's Safe Harbor for Forward-Looking Statements

Congress explicitly incorporated a "safe harbor" for projections into the PSLRA. That safe harbor provides, in relevant part, that a defendant is not liable with respect to any oral or written forward-looking statement that is identified as such and is either (1) "accompanied by meaningful cautionary

statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement" or (2) immaterial.[14] 15 U.S.C. § 78u-5(c)(1)(A)(i) & (ii). Meaningful cautionary language, however, must be substantive and tailored to the specific predictions made in the allegedly misleading statement. *In re Donald J.Trump Casino Sec. Litig. Taj Mahal Litig.*, 7 F.3d 357, 371-372 (3d Cir.1993). "A vague or blanket disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate to prevent misinformation." *Id.*

(a) Forward-Looking Statements

As an initial matter, the Complaint alleges and Plaintiffs argue that the statements at issue here are not forward-looking statements, thus the safe harbor does not apply. The Court disagrees.

The statute defines the term "forward looking statement" to include "a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure or other financial items." 15 U.S.C. § 78u-5(i)(1)(A). It also includes "a statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission." 15 U.S.C. § 78u-5(i)(1)(C). The above statements clearly constitute revenue projections and statements about Tellabs' future economic performance. Accordingly, they squarely fall within the PSLRA's definition of forward-looking statements.

(b) Cautionary Language

Defendants argue that Tellabs' revenue projections are protected by the safe harbor provisions because the revenue

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[14] The safe harbor also has a scienter element that the Court discusses *infra* at Section III.B.3.

projections at issue contained cautionary language.[15] The projections, they argue, explicitly warned investors of the risks and uncertainties associated with the forward-looking statements. Defendants contend that the projections in Tellabs' press releases, teleconferences with analysts and 10-K all contain such safe harbor language.

The January 23, March 7 and April 6, 2001 press releases at issue, for example, contained the following warnings:

> Forward-Looking Statements—This news release contains forward-looking statements that involve risks and uncertainties. Actual results may differ from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, risks associated with introducing new products, entering new markets, availability of resources, competitive response, and a downturn in the telecommunications industry. The company undertakes no obligation to revise or update these forward-looking statements to reflect events or circumstances after today or to reflect the occurrence of unanticipated events. For a more detailed description of the risk facts, please refer to the company's SEC filings.

(R. 49-1, Defs.' Appx.) Furthermore, the company made a similar disclaimer in its calls with securities analysts.[16] At

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[15] Plaintiffs argue that the question of whether such language sufficiently "cautionary" or "meaningful" to qualify under the PSLRA's safe harbor is a question of fact that is inappropriate for this Court to decide on a motion to dismiss. This argument directly contradicts the PSLRA, which explicitly provides that "the court shall consider any statement cited in the complaint and any cautionary statement accompanying the forward-looking statement" in deciding a motion to dismiss. 15 U.S.C. § 78u-5(e).

[16] The parties have not provided the Court with the transcript of the December 12, 2000 analyst call, during which Tellabs projected 30% growth for 2001, so the Court cannot conclude that the revenue projections in that call fall within the PSLRA's safe harbor.

the inception of the March 7, 2001 teleconference with the securities analysts, John Springer specifically noted:

> "Before we begin, and in keeping with the safe harbor provision of the Securities Litigation Reform Act of 1995, I would like to state that except for historical information, the following teleconference is based on preliminary financial results which are subject to further review and adjustment and contain forward-looking statements that involve risks and uncertainties. Actual results may differ from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to risks associated with introducing new products, entering new markets, availability of resources, competitive response, and the economic conditions in the telecommunications industry."

(*Id.*) He further noted that "the Company undertakes no obligation to revise or update these forward-looking statement [sic] to reflect the occurrence of unanticipated events." (*Id.*) Tellabs' 10-K for fiscal year 2000 contained even more detailed safe harbor language. (*Id.*)

The language accompanying these forward-looking statements clearly falls within the PSLRA's safe harbor for projections. Contrary to Plaintiffs' assertions, this language is not vague or boilerplate. It specifically identifies risks that could affect the projections. Accordingly, the projections are protected by the PSLRA's safe harbor.[17]

B. Scienter

Defendants also contend that Plaintiffs have failed to plead scienter with particularity for both its alleged misrepre-

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[17] Because these projections are protected by the PSLRA's safe harbor, the Court does not need to address Defendants' argument that Plaintiffs have failed to particularize the facts supporting their allegations of false projections.

sentations and projections. Rule 9(b) does "not require 'particularity' with respect to the defendants' mental state." *DiLeo*, 901 F.2d at 629. The PSLRA, however, does impose heightened pleading requirements for scienter. Specifically, the PSLRA requires that Plaintiffs "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

Under Section 10(b), scienter is either "the intent to deceive, manipulate or defraud," *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), or the "reckless disregard for the truth of the material asserted." *S.E.C. v. Jakubowski*, 150 F.3d 675, 681 (7th Cir.1998). "Reckless conduct is, at least, conduct which is highly unreasonable and which represents an extreme departure from standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." *Rehm v. Eagle Fin. Corp.*, 954 F.Supp. 1246, 1255 (N.D.Ill.1997).

The Seventh Circuit has not yet addressed the heightened pleading requirements for scienter under the PSLRA. But as this Court recently noted in *Wafra Leasing Corp. v. Prime Capital Corp.*, 247 F.Supp.2d 987 (N.D.Ill. 2002), the Second Circuit articulated a standard for scienter allegations that several other courts in this District have adopted. Under this Second Circuit standard, a plaintiff is required to allege either: (1) facts showing that the defendants had both motive and opportunity to commit fraud, or (2) facts constituting strong circumstantial evidence of conscious misbehavior or recklessness. *Id.* at 997; *see also Press v. Chemical Investment Servs. Corp.*, 166 F.3d 529, 538 (2d Cir.1999) (citations and quotations omitted). The Court rejects the Second Circuit standard because it is inconsistent with the plain language of the PSLRA. *See Wafra Leasing*, 247 F.Supp.2d at 997. Instead, Plaintiffs may use "motive and opportunity" or "circumstantial evidence" to establish scienter under the PSLRA,

as long as Plaintiffs' allegations support a strong inference that Defendants acted recklessly or knowingly. *Id.*

1. Group pleading and scienter

With respect to the alleged material misrepresentations or omissions, Plaintiffs must allege facts establishing that each individual defendant knew, or recklessly ignored, that the statements were materially false or misleading, thereby artificially inflating the price of Tellabs' stock. Group pleading allegations are insufficient under the PSLRA to establish scienter on the part of each individual Defendant. *See In re Digital Island Sec. Litig.*, 223 F.Supp.2d 546, 553 (D.Del.2002) ("courts have reasoned that the requirement under the PSLRA that scienter be pled with particularity as to each defendant would be rendered meaningless should group pleading survive"); *Chu*, 100 F.Supp.2d at 837 (rejecting the group pleading doctrine and concluding that "[t]o the extent the plaintiffs plead scienter based exclusively on an individual defendant's position in Sabratek's hierarchy, their claims must be dismissed."). Accordingly, Plaintiffs must meet the PSLRA's heightened scienter pleading requirement with respect to each Defendant.

The Complaint is replete with allegations that "Defendants" or the "Individual Defendants" acted with the requisite scienter. (*See, e.g.*, R. 40-1, Compl. ¶¶ 57, 64, 76, 113.) The Complaint is devoid of any specific allegations as to the scienter of Defendants Pullen, Ryan and Jackman. Accordingly, count one of the Complaint is dismissed without prejudice with respect to these individual defendants.

2. Scienter and Insider Trading

Plaintiffs argue that the stock sales during the purported Class Period by Defendants Birck, Gruenwald, Kohler, Kozik and Souders raise a strong inference of scienter. They contend that these Defendants personally profited from the artificially inflated stock price during the purported Class

Period, thus providing a motive for them to make the alleged misrepresentations that allegedly caused the inflated stock price.

Although the Seventh Circuit has not addressed the issue of whether insider trading allegations are sufficient to establish a strong inference of scienter, this Court agrees with the federal appellate courts that have found that mere allegations of insider trading during the purported Class Period alone are not enough to sufficiently allege a strong inference of scienter. *See e.g., In re Navarre Corp. Sec. Litig.*, 299 F.3d 735, 747 (8th Cir.2002) ("Insider stock sales are not inherently suspicious . . . ."); *Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1037 (9th Cir.2002); *Greebel*, 194 F.3d at 198 ("mere pleading of insider trading, without regard to either context or the strength of the inference to be drawn, is not enough"). It may be possible, however, for "unusual" or "suspicious" stock sales by corporate officers to constitute circumstantial evidence of scienter. *See No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920, 938 (9th Cir.2003) ("'unusual' or 'suspicious' stock sales by corporate insiders may constitute circumstantial evidence of scienter"); *In re Rockefeller Center Properties, Inc. Sec. Litig.*, 311 F.3d 198, 225 (3d Cir.2002) ("if the stock sales were unusual in scope or timing, they may support an inference of scienter."); *In re K-tel Intern., Inc. Sec. Litig.*, 300 F.3d 881, 907 (8th Cir.2002) (same); *In re Nike, Inc. Sec. Litig.*, 181 F.Supp.2d 1160, 1169 (D.Or.2002). In order to rise to the level of "unusual" or "suspicious," the insider trading must be "dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information." *In re Silicon Graphics, Inc.*, 183 F.3d at 986 (internal quotation omitted). In determining whether the insider trading allegations rise to this level, the Court can consider the amount and percentage of overall shares sold, the profit made, the timing of the stock sales and the consistency

of the sales with the insider's prior trading history. *See id.; Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 659 (8th Cir.2001) ("the insider trades have to be unusual, either in the amount of profit made, the amount of stock traded, the portion of stockholdings sold, or the number of insiders involved"); *Oran v. Stafford*, 226 F.3d 275, 290 (3d Cir.2000).

The Complaint only sets forth the number of shares of common stock that Birck, Gruenwald, Kohler, Kozik and Souders sold and the amount of trading proceeds each person received for his or her sales. Plaintiffs argue that the timing of these sales between January 31, 2001 and February 15, 2001 supports a strong inference of scienter. The Complaint, however, fails to allege the prior history of stock sales for these Defendants, the number of shares held by each Defendant or the percentage of shares each Defendant sold of his or her stock. These bare-bones stock sale allegations do not amount to anything unusual or suspicious. They clearly are insufficient by themselves to create a strong inference of scienter. *See Greebel*, 194 F.3d at 196-97; *In re E Spire*, 127 F.Supp.2d 734, 743 (D.Md.2001). This is especially true here because Plaintiffs never allege that Birck, Gruenwald, Kohler, Kozik or Souders made any misrepresentations. *See In re Visual Networks, Inc. Sec. Litig.*, 217 F.Supp.2d 662, 668-69 (D.Md.2002); *E Spire*, 127 F.Supp.2d at 743.

Plaintiffs have attached "stock sale charts" to their memorandum opposing Defendants' motion to dismiss that allegedly demonstrate the trading activity of Birck, Gruenwald, Kohler, Kozik and Souders during an eighteen month period. Not only do Plaintiffs fail to include these allegations in their Complaint, but the charts do not support their contentions. Specifically, the charts reflect that Gruenwald and Birck had stock sales prior to those in the purported Class Period. Furthermore, the charts do not contain any information regarding the total stock holdings of each of these Defendants.

Furthermore, Plaintiffs have alleged that ten Individual Defendants were part of a scheme to defraud in this case. They also allege, however, that only five of these Defendants sold stock during the purported Class Period. Given that only half of the named Defendants sold stock during the purported Class Period, Plaintiffs' motive allegations are weakened. *See San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Cos., Inc.*, 75 F.3d 801, 814 (2d Cir.1996) (strong inference of company's scienter not established by significant sale of stock by one company executive); *Rehm*, 954 F.Supp. at 1251 (finding no strong inference of scienter where two of three individuals defendants did not sell stock during class period). The Court concludes that the sale of stock alone by Birck, Gruenwald, Kohler, Kozik and Souders does not give rise to a strong inference of scienter as mandated under the PSLRA.

3. Scienter and Accounting Standards

Plaintiffs further argue that they have satisfied the scienter pleading requirements through their allegations of accounting violations. Standing alone, allegations that a defendant violated GAAP and American Institute Of Certified Public Accountants ("AICPA") accounting standards are generally insufficient to create a strong inference of scienter. *See, e.g., Navarre*, 299 F.3d at 745; *Geinko v. Padda*, No. 00 C 5070, 2001 WL 1163728, at *4 (N.D.Ill. Sept.28, 2001). Instead, to allege a strong inference of scienter, the "complaint must also show facts supporting an inference that defendants recklessly disregarded the deviance or acted with gross indifference to the misrepresentations in its financial statements." *In re System Software Assocs., Inc.*, No. 97 C 177, 2000 WL 283099, at *14 (N.D.Ill. Mar.8, 2000).

Plaintiffs allege that Defendants violated GAAP by employing improper accounting practices, which falsely inflated Tellabs' balance sheet. Plaintiffs claim that Defendants caused Tellabs to violate GAAP by improperly accelerating

revenues through "channel stuffing." The Court addressed the insufficiency of the "channel stuffing" allegations in Section III. Specific to scienter, Plaintiffs have not alleged sufficient facts to show that Defendants knew or recklessly disregarded at the time of making the transactions that customers would be returning products in the first quarter of 2001.

Similarly, Plaintiffs allege that Defendants violated GAAP by neglecting to write-off obsolete inventory until the second quarter of 2001. The Court also addressed the deficiencies in the pleading of this scheme in Section III. As with "channel stuffing" scienter, Plaintiffs have not alleged sufficient facts to show that Plaintiffs had scienter when failing to write-off the obsolete inventory during the fourth quarter of 2001.

4. Other Scienter Allegations

Plaintiffs also contend that the Individual Defendants knew facts or recklessly disregarded information at their disposal that contradicted their public statements. As noted above, however, they do not individualize their allegations as to each of these Defendants, as they must. Conclusory allegations of reckless disregard are insufficient to raise a strong inference of scienter. *See In re Azurix Corp. Sec. Litig.*, 198 F.Supp.2d 862, 891 (S.D.Tex.2002).

In addition, Plaintiffs rely on the Defendants' positions within Tellabs in support of their scienter argument. "A pleading of scienter may not rest on the inference that defendants must have been aware of the misstatement based on their positions within the company." *Abrams v. Baker Hughes Inc.*, 292 F.3d 424, 432 (5th Cir.2002). Accordingly, this argument fails as well.

With respect to Tellabs itself, Plaintiffs have not alleged how an individual's knowledge can be imputed to the corporation to find that it had the requisite scienter. This is an important allegation because only the knowledge obtained

by corporate employees acting within the scope of their employment can be imputed to the corporation. *United States v. One Parcel of Land*, 965 F.2d 311, 315 (7th Cir.1992). Although the majority of the allegedly misleading statements were made in company documents, such as press releases and the Company's 10-Ks, Plaintiffs have not alleged with any particularity which officers, directors, or employees acting within their scope of duties had knowledge that the statements were misleading.. [sic]

5. Projections

The PSLRA imposes an even higher pleading burden for projections or forward-looking statements. The PSLRA specifically states that a defendant will be liable for a forward-looking statement only where it "was made with actual knowledge . . . that the statement was false or misleading." 15 U.S.C. § 78u-5(c)(1)(B)(i). *See also Theoharous v. Fong*, 256 F.3d 1219, 1225 (11th Cir.2001) (with respect to forward-looking statements, "the plaintiff must prove that the defendant made the statement with 'actual knowledge' that it was 'false or misleading.'"); *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 549 & n. 5 (6th Cir.1999) (noting that the PSLRA requires plaintiffs to allege facts that raise a strong inference that the defendants had actual knowledge of a forwardlooking statement's falsity). Thus, under the plain language of the statute mere allegations of recklessness are insufficient to establish liability for projections. For the reasons discussed above, Plaintiffs' allegations fail to raise a strong inference of actual knowledge on the part of any of the Defendants.

V. Count Two—Section 20(a) Liability

Count two seeks liability against the Individual Defendants for violating Section 20(a) of the Exchange Act. Section 20(a) provides: "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or

of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78t(a).

Plaintiffs must allege the following in order to state a Section 20(a) claim: (1) a primary securities violation; (2) each of the Individual Defendants exercised general control over the operations of Tellabs; and (3) each of the Individual Defendants "possessed the power or ability to control the specific transaction or activity upon which the primary violation was predicated, whether or not that power was exercised." *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 881 (7th Cir.1992). Because Plaintiffs' Section 20(a) claim is one of fraud, Plaintiffs must meet the heightened pleading requirements of Federal Rule of Civil Procedure 9(b). Plaintiffs, however, need not meet the heightened pleading requirements of the PSLRA to establish control person liability.

Defendants argue that the Court should dismiss count two for failure to state a claim for control person liability under Section 20(a) on the following grounds: (1) Plaintiffs fail to allege a predicate securities fraud violation; and (2) Plaintiffs fail to allege that Defendants Gruenwald, Kohler, Puller or Souders exercised sufficient control over Tellabs to be held liable as control persons. As discussed above, the Court agrees that Plaintiffs have failed to allege a predicate Section 10(b) violation on the part of the Individual Defendants. Consequently, count two is dismissed without prejudice as to the Individual Defendants.

Moreover, the Court agrees that the Complaint does not provide sufficient allegations to conclude that Defendants Gruenwald, Kohler, Puller or Souders possessed the power or

ability to control the alleged misrepresentations and projections. The Complaint does not allege any facts to demonstrate that these Defendants were control persons or served in high-level officer positions. Gruenwald was the senior vice president and general manager of the broadband access group, Kohler was the senior vice president of global business operations, Pullen was the senior vice president and general manager of optical networking and Souders was an outsider director of Tellabs. Although Plaintiffs generally allege that these Individual Defendants "had direct and supervisory involvement in the day-to-day operations of the Company and, therefore, are presumed to have had the power to control or influence the particular transactions giving rise to the securities violations," this general allegation as to all the Individual Defendants is insufficient to establish control person liability. *See Donovan*, 2002 WL 1553259 at *6 (N.D.Ill. July 15, 2002) ("The mere fact that Plaintiff alleges these Defendants are directors is not enough" for control person liability). Accordingly, count two is dismissed without prejudice as to Defendants Gruenwald, Kohler, Puller or Souders.

VI. Count Three—Insider Trading Claim

Plaintiffs have sued Defendants Birck, Kozik, Kohler, Souders and Gruenwald in count three for insider trading pursuant to Section 20A of the Exchange Act. Section 20A expressly provides for a private cause of action against persons who purchase or sell a security "while in possession of material, nonpublic information." Such an action may be brought by "any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased . . . or sold . . . securities of the same class." *United States v. O'Hagan*, 521 U.S. 642, 666, 117 S.Ct. 2199, 2214, 138 L.Ed.2d 724 (1997) (quoting 15 U.S.C. § 78t-1(a)); *see also Fujisawa Pharmaceutical Co., Ltd. v. Kapoor*, 115 F.3d 1332, 1337 (7th Cir.1997). Because Plain-

tiffs have failed to allege that Defendants Birck, Kozik, Kohler, Souders and Gruenwald were in possession of material, nonpublic information when they sold their stock, count three of the Complaint is dismissed without prejudice.

CONCLUSION

Defendants' motion to dismiss is granted. Plaintiffs have until June 27, 2003 to file a Second Consolidated Amended Complaint.

APPENDIX D

UNPUBLISHED ORDER
Not to be cited per Circuit Rule 53

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

July 10, 2006

Before

Hon. KENNETH F. RIPPLE, *Circuit Judge*

Hon. DIANE P. WOOD, *Circuit Judge*

Hon. DIANE S. SYKES, *Circuit Judge*

No. 04-1687

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
Plaintiffs-Appellants,

v.

TELLABS, INC., *et al.*,
Defendants-Appellees.

No. 02 C 04356
Amy J. St. Eve, *Judge*.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

ORDER ON PETITION FOR REHEARING

Defendants-Appellees filed a petition for rehearing *en banc* on February 8, 2006. No judge in active service has requested a vote on the petition for rehearing *en banc*.

All members of the original panel have voted to DENY rehearing except to the extent that the opinion is MODIFIED as follows: the first full paragraph on page 28 of the slip of the opinion is deleted and replaced with the following:

> The plaintiffs also pleaded a claim against Birck for insider trading. A private cause of action exists under § 20A of the Securities Exchange Act against persons who purchase or sell a security "while in possession of material, nonpublic information." See 15 U.S.C. § 78t-1(a). To create potential liability under § 20A, the plaintiffs must prove an independent violation of "this chapter or the rules or regulations thereunder." *Id.* In other words, § 20A claims are "derivative, requiring proof of a separate underlying violation of the Exchange Act." *Advanta Corp.*, 180 F.3d at 541. At this point in the litigation, we have affirmed the dismissal of the underlying securities fraud claims pleaded directly against Birck. He still faces liability, but solely as a control person under § 20(a). Whether § 20(a) control-person liability standing alone can serve as the "separate underlying violation" required for § 20A insider trading is an open question of law and raises an important issue of statutory interpretation that should not be decided in a vacuum. No party in this litigation has provided more than cursory briefing of this issue, and therefore we take no position on its resolution, leaving it for further factual and legal development during the course of the litigation.

Supreme Court, U.S.
FILED
DEC 6 - 2006
OFFICE OF THE CLERK

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No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED and RICHARD C. NOTEBAERT,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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STATEMENT PURSUANT TO RULE 29.6

Respondent, Makor Issues&Rights Ltd., is the only respondent in corporate form and is wholly owned by Gruner Investments Anstalt, Vaduz, Liechtenstein (a private company).

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STATUTES

15 U.S.C. § 78u-4(b)(2) 1

REASONS FOR DENYING THE PETITION

The petition for a writ of certiorari should be denied. The United States Court of Appeals for the Seventh Circuit properly recognized and applied the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 (the "PSLRA"), and, in particular, the requirement that the plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." PSLRA § 21D(b)(2), 15 U.S.C. § 78u-4(b)(2). The Seventh Circuit did not, as Petitioners contend, employ an inappropriately lax standard that was at odds with either the express language of the PSLRA or the interpretation of the statute adopted by other Circuits. Petitioners expend enormous energy portraying the existing case law as inconsistent, divided, and chaotic. In truth, much of what Petitioners focus on are really only differences in semantics, not substance. In any event, the allegations in this case are so strong and highly particularized that the Complaint satisfies any formulation of the PSLRA pleading requirements. As such, this is an inappropriate case for this Court to address the PSLRA pleading standard.

I. PETITIONERS MISREPRESENT THE STANDARD APPLIED BY THE SEVENTH CIRCUIT

Straining to create an issue for review, Petitioners suggest that the Seventh Circuit — in its unanimous decision — applied an improperly "lax" standard in adjudging that Respondents adequately pled scienter under the PSLRA. *See, e.g.*, Pet. at 23 ("The Seventh Circuit has allowed a plaintiff to plead facts from which a reasonable person conceivably '***could***' draw an inference of scienter."). Petitioners are wrong. The Seventh Circuit properly recognized that,

although the PSLRA "did not impose a more stringent substantive scienter standard, ***it did unequivocally raise the bar for pleading scienter***." Pet. App. A at 18a (emphasis added). "Not only must plaintiffs meet a particularity requirement; they must also meet a substantive requirement by pleading sufficient facts to create '***a strong inference' of scienter***." *Id.* (emphasis added). The Seventh Circuit observed:

> Unlike a run-of-the-mill complaint, which will survive a motion to dismiss for failure to state a claim so long as it is "possible to hypothesize a set of facts, consistent with the complaint, that would entitle the plaintiff to relief," ***the PSLRA essentially returns the class of cases it covers to a very specific version of fact pleading — one that exceeds even the particularity requirement of Federal Rule of Civil Procedure 9(b)***.

Id. at 6a-7a (emphasis added) (citation omitted).

After addressing various errors in the District Court's decision dismissing the Second Amended Consolidated Class Action Complaint (the "Complaint"), the Seventh Circuit stated:

> All of this will not affect the ultimate outcome of this case, however, ***unless the plaintiffs can clear another, even more arduous, hurdle: adequately alleging scienter***. In passing the PSLRA, some in Congress recorded their belief that Federal Rule of Civil Procedure 9(b) had "not prevented abuse of the securities laws by private litigants." To address this perceived abuse, the PSLRA

> changes the threshold pleading rules by requiring that the complaint ". . . state with particularity facts giving rise to a ***strong inference*** that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

Id. at 16a-17a (emphasis added) (citation omitted). The Court also stated:

> Under the PSLRA, a securities fraud complaint must . . . "state with particularity facts giving rise to a ***strong inference*** that the defendant acted with the required state of mind." In other words, ***plaintiffs must not only plead a violation with particularity; they must also marshal sufficient facts to convince a court at the outset that defendants likely intended "to deceive, manipulate, or defraud."***

Id. at 7a (emphasis added). *See also id.* at 1a (noting "the ***heightened pleading requirements*** of the [PSLRA]") (emphasis added); *id.* at 22a ("We can now assess whether the complaint states, with respect to each of these actionable statements, facts that give rise to a ***strong inference of scienter***.") (emphasis added); *id.* at 23a ("Creating the required ***strong inference that Birck***[1] ***knew*** about the 5500's market weakness is more difficult.") (emphasis added); *id.* at 24a ("a ***strong inference of scienter***") (emphasis added); *id.* at 25a ("***strong inference that Notebaert***[2] ***knew***") (emphasis added).[3]

---

1. Michael J. Birck, Tellabs' Chairman and former CEO.

2. Richard C. Notebaert, Tellabs' CEO and President.

3. In addition, the Seventh Circuit made clear that a plaintiff must establish the requisite "strong inference" of scienter with respect

(Cont'd)

In fact, the phrase "strong inference" appears no fewer than twenty times in the Seventh Circuit's opinion, and nowhere in the opinion does the Court state that anything less than a "strong inference" will suffice to meet the pleading requirements of the PSLRA.

II. THE COMPLAINT PLEADS FACTS THAT GIVE RISE TO A "STRONG INFERENCE" OF SCIENTER UNDER ANY FORMULATION OF THE PSLRA STANDARD

This is not the sort of marginal case the PSLRA was intended to address. The Complaint passes muster even under the most restrictive formulation of the PSLRA pleading requirements. Accordingly, this is not the appropriate case for this Court to address whatever variations may exist among the Circuits in the articulation of the "strong inference" standard.

The Complaint is unusually detailed in that, among other things, it identifies 27 confidential sources — all closely connected with Tellabs — with knowledge and information concerning the Company's serious problems and Petitioners' awareness thereof. The Complaint specifies the position held by each source and the dates of his or her employment with the Company. The Seventh Circuit explained:

(Cont'd)

to each defendant: "While we will aggregate the allegations in the complaint to determine whether it creates a ***strong inference of scienter, plaintiffs must create this inference with respect to each individual defendant*** in multiple defendant cases." Pet. App. A at 22a (emphasis added).

> The list includes former managers and high-level executives. The descriptions provided in the complaint reveal that many of the informants were in a position to provide reliable information concerning whether Birck's and Notebaert's statements were false and material and whether Birck and Notebaert knew this to be the case.

Pet. App. A at 11a.[4]

The Seventh Circuit found that the Complaint provides detailed facts to support the allegation that, by January 2001, demand for Tellabs' "best seller" — the TITAN 5500 — was

4. The confidential sources, who corroborate each other and who are corroborated by other facts pleaded in the Complaint, include: two "Tellabs marketing manager[s]," a "Tellabs executive account manager and regional manager," three "high-level Tellabs sales executive[s]," a "Tellabs shipping supervisor," a "mid-level Tellabs employee involved in distribution," a "Tellabs senior business manager," two "Tellabs sales director[s]," a "Tellabs project manager," a "Tellabs customer accounts representative," a "Tellabs regional sales director," a "Tellabs installations supervisor," a "Tellabs sales manager," a "Tellabs materials manager," a "Tellabs manager in the business development area," a "Tellabs marketing strategy executive," a "Tellabs market analyst," a "high-level SALIX/ Tellabs operations executive," a "Tellabs operations manager," a "Tellabs engineer who held a variety of management positions at Tellabs," a "Tellabs senior designer," a "Tellabs customer manager," a "Tellabs team project manager," and a "Tellabs consultant who worked for value added resellers [*i.e.*, "third parties that work along with Tellabs to handle customer services, including engineering site surveys, installations, and testing services" and "also act as distributors of Tellabs' products"]." Twenty-six of the twenty-seven sources were at Tellabs during the Class Period. (One high-level sales executive who worked at the Company for many years left just prior to the Class Period.) Complaint at 1-4.

declining, including that Verizon, Tellabs' largest customer, reduced its orders for the TITAN 5500 by roughly 25% in late 2000 and by roughly 50% in January 2001; that customers in Latin America and Central America were no longer buying the product; that, by late 2000, according to a couple of confidential sources, Tellabs had excess TITAN 5500s on hand because of a lack of demand; that one confidential source revealed that Tellabs paid Probe Research, an outside company, $100,000 to forecast demand for the TITAN 5500; that the report, which was completed "in or about early 2001," showed that the market need for the TITAN 5500 was evaporating; and that, based on that research, Tellabs' marketing strategy department distributed an internal memorandum concluding that revenue from the TITAN 5500 could decline by about $400 million. Pet. App. A at 11a. In light of the serious problems affecting the TITAN 5500, the Seventh Circuit found actionable:

> — Notebaert's assurance during a March 8, 2001 conference call with analysts: "We're still seeing [the TITAN 5500] . . . maintain its growth rate; it's still experiencing strong acceptance."[5]
>
> — The response by Notebaert and Birck in Tellabs' 2000 Annual Report, published in February 2001, to the frequently asked question, "[A]re you worried that the [TITAN 5500] has peaked?" Petitioners stated, without qualification, "No. . . . Although we introduced the product nearly 10 years ago, it's still going strong."

Id. at 12a.

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5. The District Court, too, held this statement to be actionable. Pet. App. B at 50a.

The Seventh Circuit also held, as did the District Court (Pet. App. B at 52a-53a), that Petitioners' representations concerning the purported availability of, and demand for, the TITAN 6500, one of Tellabs' most significant new products, were actionable in light of the Complaint's allegations that the TITAN 6500 was, in fact, far behind schedule, failing lab tests, and not ready for release (*id.* at 32a, 51a[6]). Thus, both the Seventh Circuit, and the District Court, determined that Respondents adequately alleged that the following statements were deceptive:

> — On December 11, 2000, the first day of the Class Period, Tellabs flatly stated, "The TITAN 6500 system is available now."
>
> — On March 8, 2001, Notebaert told analysts, "Interest in and demand for the 6500 continues to grow. . . . We continue to ship . . . 6500 through the first quarter. We are satisfying very strong demand and growing customer demand."
>
> — Again, on April 6, 2001, in response to an analyst's question whether Tellabs was still on track to recognize TITAN 6500 revenue in the second quarter, Notebaert stated, "we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong."

Pet. App. A at 13a.

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6. The District Court noted: "Plaintiffs support their allegations [regarding the TITAN 6500] with information from numerous confidential sources who worked at Tellabs." Pet. App. B at 51a.

The Seventh Circuit further concluded, as did the District Court, that Plaintiffs pled "with sufficient particularity . . . the charge that Tellabs flooded its downstream customers with unordered TITAN 5500s" and therefore adequately alleged that Defendants falsely represented Tellabs' financial results for the fourth quarter of 2000:

> According to the plaintiffs' confidential sources, Tellabs had to lease extra storage space in January and February 2001 to accommodate the large number of returns.
>
> ***While there may be legitimate reasons for attempting to achieve sales earlier via channel stuffing, providing excess supply to distributors in order to create a misleading impression in the market of the company's financial health is not one of them.*** The complaint relies on several confidential sources to support the channel stuffing allegation. For example, one source informed class counsel that Verizon's chairman had asked Tellabs to stop providing Verizon, Tellabs's largest customer, with products that Verizon did not request or require. Given the consistency and specificity of the plaintiffs' channel stuffing allegations, the district court found, and we agree, that the amended complaint provided sufficient detail of channel stuffing to overcome the PSLRA's material falsity hurdle.

Id. at 14a (emphasis added).[7, 8]

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7. The District Court found the allegations of channel stuffing, as well as allegations of backdating sales, to be sufficiently particularized. Pet. App. B at 56a-58a. The District Court noted:

(Cont'd)

The Seventh Circuit then determined, with respect to each of the actionable misstatements, that the Complaint alleges "facts that give rise to a ***strong inference*** of scienter" (emphasis added) on the part of Notebaert and, since Notebaert was Tellabs' CEO, on the part of the Company as well:

> First, as for the TITAN 5500, the Probe Research report revealed, "in or about early 2001," that the market for the TITAN 5500 had faded. In reaction to this news, Tellabs's marketing strategy department concluded that revenue from the TITAN 5500 would decline by about $400 million. According to one confidential source, a Tellabs market analyst who worked for the company throughout the class period, internal reports

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(Cont'd)

> Plaintiffs back their contentions [of channel stuffing] with allegations supported by at least 8 separate confidential sources with personal knowledge that Tellabs provided customers with products that the customers did not want. . . . These sources corroborate each other and suggest that the information is reliable. Plaintiffs identify specific customers whom Tellabs allegedly over-inventoried, namely Telcobuy and Verizon.

Id. at 56a-57a.

8. The Seventh Circuit noted, as well, that Plaintiffs "identify a series of what turned out to be overstated revenue projections made by Tellabs, which, according to the complaint, were meant to induce investors to purchase Tellabs stock." Pet. App. A at 14a. The Seventh Circuit held that "Tellabs's warnings were not particularized enough for it to claim shelter under the PSLRA's safe harbor provision." *Id.* at 16a.

> revealed by March 2001 that the market for the 5500 was drying up. Yet, in April 2001, Notebaert told financial analysts that "everything we hear from the customers indicates that our in-user demand for services continues to grow." While it is conceivable that Notebaert had yet to see the reports suggesting his company was in trouble ("in or about early 2001" is somewhat vague), the plaintiffs have provided enough for a reasonable person to infer that Notebaert knew that his statements were false. According to another confidential source, a Tellabs business manager, Notebaert stayed on top of the company's financial health through weekly conversations with his fellow executives. Given the significance of the TITAN 5500 and the number of reports suggesting that it was in trouble, we find it sufficiently probable that Notebaert had information suggesting that his statements were false.

Id. at 23a.[9]

With respect to Notebaert's awareness that the representations regarding the availability of the TITAN 6500 were false, the Seventh Circuit stated:

> According to the complaint, Notebaert made a number of false statements regarding the 6500, suggesting that it was available and being shipped, when, in fact, Tellabs did not ship a single TITAN

9. Evidencing its close attention to the heightened PSLRA pleading standards, the Seventh Circuit concluded that "the plaintiffs did not meet the strict PSLRA standards for pleading Birck's scienter." Pet. App. A at 24a.

> 6500 during the class period. If it is true that the TITAN 6500 was not in fact available during the class period, it is hard to accept that Notebaert's statements were simply honest mistakes. According to a Tellabs sales director, Notebaert saw weekly sales reports and production projections. Another confidential source, a former high-level sales executive, reported that Notebaert knew that "the TITAN 6500 was not ready for deployment despite Tellabs'[s] public announcements." We conclude that the plaintiffs have pleaded sufficient facts to "giv[e] rise to a ***strong inference***," 15 U.S.C. § 78u-4(b)(2), ***that Notebaert knowingly lied*** when he informed investors that the 6500 was "available now" and was "being shipped."

Id. at 24a-25a (emphasis added).

The Seventh Circuit also found that, as with the TITAN 5500 and 6500, the Complaint "contains enough detail to establish a ***strong inference*** that Notebaert knew of the channel stuffing and therefore knew Tellabs had exaggerated its fourth quarter 2000 revenues." *Id.* at 25a (emphasis added). The Court stated:

> Indeed, a former senior business manager at Tellabs informed the plaintiffs that Notebaert "worked directly with Tellabs' sales personnel" to effect the channel stuffing. Another confidential source, a high-level sales executive, admitted that his employees fabricated purchase orders for products that customers had not ordered. He

> claimed that Notebaert "unquestionably knew" about the channel stuffing.

Id.[10] The extraordinarily detailed Complaint satisfies any Circuit's formulation of the PSLRA pleading standard.

Petitioners try to make much of the Seventh Circuit's failure to take account of purported "competing innocent inferences" to be drawn from facts alleged in the Complaint. *See, e.g.*, Pet. at 15. Yet, fairly considered, there are no competing innocent inferences to be weighed against the powerful inferences of culpability in this case. Accordingly, whether or not inferences of an innocent mental state are considered and balanced against the inferences of scienter would not affect the outcome of this case. The inferences of culpability are not only the most plausible or the stronger inferences to be drawn here, they are the ***only*** inferences.

Petitioners' argument that "the record revealed no apparent motive for Notebaert to engage in fraud . . . or any benefit either to him or the company" (Pet. at 15) defies common sense. Notebaert, whose livelihood and business reputation depended on the success of the Company, no doubt was extremely concerned with its well-being. The public revelation of significant problems affecting Tellabs' key products, including that one of its most important new products, the TITAN 6500, was not ready for release, surely would have jeopardized the Company's performance and prospects in a highly competitive and troubled market.

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10. The Seventh Circuit further determined: "since the allegedly overstated revenue projections rest on the company's statements that its products were doing better than they actually were, the scienter for those alleged misrepresentations serves as sufficient circumstantial evidence of scienter here." Pet. App. A at 25a-26a.

Notebaert's natural desire to protect his Company from the adverse effects of publicizing that the products on which its fortunes depended were not selling and did not work makes complete sense. *See Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 656 (8th Cir. 2001) ("common sense would suggest that [defendant's desire to maintain company's profitability or credit rating] may be the very motives that prompt many cases of deceptive misstatements").[11]

Moreover, motive is not an essential element of a § 10(b) claim.[12] *See Novak v. Kasaks*, 216 F.3d 300, 306, 311 (2d Cir. 2000). The Seventh Circuit (Pet. App. A at 17a-18a) and virtually every other Court of Appeals that has considered the issue[13] have recognized that reckless disregard for the truth still constitutes scienter under § 10(b).

Nor do Tellabs' announcements on April 6 and April 18, 2001, in which the Company, among other things, modified

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11. No inference adverse to Respondents should be drawn from the fact that Notebaert did not risk his reputation, property, or liberty by not engaging in illegal insider selling of Tellabs stock while in possession of material nonpublic information.

12. In addition, because Respondents did not have access to discovery when drafting the Complaint, it would be unfair to require them to know or speculate as to what was in Petitioners' minds.

13. *See, e.g., Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 343-44 (4th Cir. 2003); *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1095 (10th Cir. 2003); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 38 (1st Cir. 2002); *Green Tree*, 270 F.3d at 653-54; *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 407-09 (5th Cir. 2001); *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 76-77 (2d Cir. 2001); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 548, 550 (6th Cir. 2001); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1283 (11th Cir. 1999); *In re Advanta Sec. Litig.*, 180 F.3d 525, 535 (3d Cir. 1999).

its previous guidance, give rise to an innocent inference. Tellabs revised its estimates of 2001 performance only when the release of disappointing first quarter 2001 results forced its hand. Moreover, at the very same time Tellabs modified its guidance, Notebaert falsely assured analysts that Tellabs was still on track to recognize TITAN 6500 revenue in the second quarter: "[W]e should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong." The Seventh Circuit found these statements actionable. Pet. App. A at 13a.

Likewise, Tellabs' attempt to accelerate sales by channel stuffing can hardly be viewed as innocent in light of the Complaint's allegations that, according to one confidential source (a high-level Tellabs sales executive), Tellabs employees actually fabricated purchase orders for products customers had not ordered (Pet. App. A at 25a); that, according to another source, Tellabs sent unwanted TITAN 5500s to such customers as Verizon and Telcobuy (Pet. App. B at 56a-57a); and that the Chairman of Verizon, Tellabs' largest customer, even called Tellabs to complain about channel stuffing (Pet. App. A at 14a). Yet another source, a Tellabs marketing manager, revealed that, to pull TITAN 5500 sales to such large customers as SBC and Sprint from the first quarter 2001 into the fourth quarter 2000, Tellabs backdated sales. Pet. App. B at 58a.

In short, considered individually and cumulatively, the facts alleged compel a powerful inference of scienter that would satisfy even the most stringent reading of the PSLRA. The Complaint supports an inescapable inference that Petitioner Notebaert, who was responsible for managing the Company at the very highest level, was fully aware that the very serious problems affecting sales of Tellabs' core products jeopardized

the Company's overall performance and prospects. *See, e.g.*, *Kinder-Morgan*, 340 F.3d at 1106; *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.*, 320 F.3d 920, 943 n.21 (9th Cir. 2003); *Zonagen*, 267 F.3d at 424-25; *Advanta Corp.*, 180 F.3d at 539.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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Supreme Court, U.S.
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No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED and RICHARD C. NOTEBAERT,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF IN OPPOSITION

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STATEMENT PURSUANT TO RULE 29.6

Respondent, Makor Issues&Rights Ltd., is the only respondent in corporate form and is wholly owned by Gruner Investments Anstalt, Vaduz, Liechtenstein (a private company).

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STATUTES

15 U.S.C. § 78u-4(b)(2) 1

REASONS FOR DENYING THE PETITION

The petition for a writ of certiorari should be denied. The United States Court of Appeals for the Seventh Circuit properly recognized and applied the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 (the "PSLRA"), and, in particular, the requirement that the plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." PSLRA § 21D(b)(2), 15 U.S.C. § 78u-4(b)(2). The Seventh Circuit did not, as Petitioners contend, employ an inappropriately lax standard that was at odds with either the express language of the PSLRA or the interpretation of the statute adopted by other Circuits. Petitioners expend enormous energy portraying the existing case law as inconsistent, divided, and chaotic. In truth, much of what Petitioners focus on are really only differences in semantics, not substance. In any event, the allegations in this case are so strong and highly particularized that the Complaint satisfies any formulation of the PSLRA pleading requirements. As such, this is an inappropriate case for this Court to address the PSLRA pleading standard.

I. PETITIONERS MISREPRESENT THE STANDARD APPLIED BY THE SEVENTH CIRCUIT

Straining to create an issue for review, Petitioners suggest that the Seventh Circuit — in its unanimous decision — applied an improperly "lax" standard in adjudging that Respondents adequately pled scienter under the PSLRA. *See, e.g.*, Pet. at 23 ("The Seventh Circuit has allowed a plaintiff to plead facts from which a reasonable person conceivably '***could***' draw an inference of scienter."). Petitioners are wrong. The Seventh Circuit properly recognized that,

although the PSLRA "did not impose a more stringent substantive scienter standard, ***it did unequivocally raise the bar for pleading scienter***." Pet. App. A at 18a (emphasis added). "Not only must plaintiffs meet a particularity requirement; they must also meet a substantive requirement by pleading sufficient facts to create '***a strong inference' of scienter***." *Id.* (emphasis added). The Seventh Circuit observed:

> Unlike a run-of-the-mill complaint, which will survive a motion to dismiss for failure to state a claim so long as it is "possible to hypothesize a set of facts, consistent with the complaint, that would entitle the plaintiff to relief," ***the PSLRA essentially returns the class of cases it covers to a very specific version of fact pleading — one that exceeds even the particularity requirement of Federal Rule of Civil Procedure 9(b)***.

Id. at 6a-7a (emphasis added) (citation omitted).

After addressing various errors in the District Court's decision dismissing the Second Amended Consolidated Class Action Complaint (the "Complaint"), the Seventh Circuit stated:

> All of this will not affect the ultimate outcome of this case, however, ***unless the plaintiffs can clear another, even more arduous, hurdle: adequately alleging scienter***. In passing the PSLRA, some in Congress recorded their belief that Federal Rule of Civil Procedure 9(b) had "not prevented abuse of the securities laws by private litigants." To address this perceived abuse, the PSLRA

> changes the threshold pleading rules by requiring that the complaint ". . . state with particularity facts giving rise to a ***strong inference*** that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

Id. at 16a-17a (emphasis added) (citation omitted). The Court also stated:

> Under the PSLRA, a securities fraud complaint must . . . "state with particularity facts giving rise to a ***strong inference*** that the defendant acted with the required state of mind." In other words, ***plaintiffs must not only plead a violation with particularity; they must also marshal sufficient facts to convince a court at the outset that defendants likely intended "to deceive, manipulate, or defraud."***

Id. at 7a (emphasis added). *See also id.* at 1a (noting "the ***heightened pleading requirements*** of the [PSLRA]") (emphasis added); *id.* at 22a ("We can now assess whether the complaint states, with respect to each of these actionable statements, facts that give rise to a ***strong inference of scienter***.") (emphasis added); *id.* at 23a ("Creating the required ***strong inference that Birck***[1] ***knew*** about the 5500's market weakness is more difficult.") (emphasis added); *id.* at 24a ("a ***strong inference of scienter***") (emphasis added); *id.* at 25a ("***strong inference that Notebaert***[2] ***knew***") (emphasis added).[3]

---

1. Michael J. Birck, Tellabs' Chairman and former CEO.

2. Richard C. Notebaert, Tellabs' CEO and President.

3. In addition, the Seventh Circuit made clear that a plaintiff must establish the requisite "strong inference" of scienter with respect (Cont'd)

In fact, the phrase "strong inference" appears no fewer than twenty times in the Seventh Circuit's opinion, and nowhere in the opinion does the Court state that anything less than a "strong inference" will suffice to meet the pleading requirements of the PSLRA.

II. THE COMPLAINT PLEADS FACTS THAT GIVE RISE TO A "STRONG INFERENCE" OF SCIENTER UNDER ANY FORMULATION OF THE PSLRA STANDARD

This is not the sort of marginal case the PSLRA was intended to address. The Complaint passes muster even under the most restrictive formulation of the PSLRA pleading requirements. Accordingly, this is not the appropriate case for this Court to address whatever variations may exist among the Circuits in the articulation of the "strong inference" standard.

The Complaint is unusually detailed in that, among other things, it identifies 27 confidential sources — all closely connected with Tellabs — with knowledge and information concerning the Company's serious problems and Petitioners' awareness thereof. The Complaint specifies the position held by each source and the dates of his or her employment with the Company. The Seventh Circuit explained:

(Cont'd)

to each defendant: "While we will aggregate the allegations in the complaint to determine whether it creates a ***strong inference of scienter, plaintiffs must create this inference with respect to each individual defendant*** in multiple defendant cases." Pet. App. A at 22a (emphasis added).

> The list includes former managers and high-level executives. The descriptions provided in the complaint reveal that many of the informants were in a position to provide reliable information concerning whether Birck's and Notebaert's statements were false and material and whether Birck and Notebaert knew this to be the case.

Pet. App. A at 11a.[4]

The Seventh Circuit found that the Complaint provides detailed facts to support the allegation that, by January 2001, demand for Tellabs' "best seller" — the TITAN 5500 — was

4. The confidential sources, who corroborate each other and who are corroborated by other facts pleaded in the Complaint, include: two "Tellabs marketing manager[s]," a "Tellabs executive account manager and regional manager," three "high-level Tellabs sales executive[s]," a "Tellabs shipping supervisor," a "mid-level Tellabs employee involved in distribution," a "Tellabs senior business manager," two "Tellabs sales director[s]," a "Tellabs project manager," a "Tellabs customer accounts representative," a "Tellabs regional sales director," a "Tellabs installations supervisor," a "Tellabs sales manager," a "Tellabs materials manager," a "Tellabs manager in the business development area," a "Tellabs marketing strategy executive," a "Tellabs market analyst," a "high-level SALIX/ Tellabs operations executive," a "Tellabs operations manager," a "Tellabs engineer who held a variety of management positions at Tellabs," a "Tellabs senior designer," a "Tellabs customer manager," a "Tellabs team project manager," and a "Tellabs consultant who worked for value added resellers [*i.e.*, "third parties that work along with Tellabs to handle customer services, including engineering site surveys, installations, and testing services" and "also act as distributors of Tellabs' products"]." Twenty-six of the twenty-seven sources were at Tellabs during the Class Period. (One high-level sales executive who worked at the Company for many years left just prior to the Class Period.) Complaint at 1-4.

declining, including that Verizon, Tellabs' largest customer, reduced its orders for the TITAN 5500 by roughly 25% in late 2000 and by roughly 50% in January 2001; that customers in Latin America and Central America were no longer buying the product; that, by late 2000, according to a couple of confidential sources, Tellabs had excess TITAN 5500s on hand because of a lack of demand; that one confidential source revealed that Tellabs paid Probe Research, an outside company, $100,000 to forecast demand for the TITAN 5500; that the report, which was completed "in or about early 2001," showed that the market need for the TITAN 5500 was evaporating; and that, based on that research, Tellabs' marketing strategy department distributed an internal memorandum concluding that revenue from the TITAN 5500 could decline by about $400 million. Pet. App. A at 11a. In light of the serious problems affecting the TITAN 5500, the Seventh Circuit found actionable:

> — Notebaert's assurance during a March 8, 2001 conference call with analysts: "We're still seeing [the TITAN 5500] . . . maintain its growth rate; it's still experiencing strong acceptance."[5]
>
> — The response by Notebaert and Birck in Tellabs' 2000 Annual Report, published in February 2001, to the frequently asked question, "[A]re you worried that the [TITAN 5500] has peaked?" Petitioners stated, without qualification, "No. . . . Although we introduced the product nearly 10 years ago, it's still going strong."

Id. at 12a.

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5. The District Court, too, held this statement to be actionable. Pet. App. B at 50a.

The Seventh Circuit also held, as did the District Court (Pet. App. B at 52a-53a), that Petitioners' representations concerning the purported availability of, and demand for, the TITAN 6500, one of Tellabs' most significant new products, were actionable in light of the Complaint's allegations that the TITAN 6500 was, in fact, far behind schedule, failing lab tests, and not ready for release (*id.* at 32a, 51a[6]). Thus, both the Seventh Circuit, and the District Court, determined that Respondents adequately alleged that the following statements were deceptive:

> — On December 11, 2000, the first day of the Class Period, Tellabs flatly stated, "The TITAN 6500 system is available now."
>
> — On March 8, 2001, Notebaert told analysts, "Interest in and demand for the 6500 continues to grow. . . . We continue to ship . . . 6500 through the first quarter. We are satisfying very strong demand and growing customer demand."
>
> — Again, on April 6, 2001, in response to an analyst's question whether Tellabs was still on track to recognize TITAN 6500 revenue in the second quarter, Notebaert stated, "we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong."

Pet. App. A at 13a.

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6. The District Court noted: "Plaintiffs support their allegations [regarding the TITAN 6500] with information from numerous confidential sources who worked at Tellabs." Pet. App. B at 51a.

The Seventh Circuit further concluded, as did the District Court, that Plaintiffs pled "with sufficient particularity . . . the charge that Tellabs flooded its downstream customers with unordered TITAN 5500s" and therefore adequately alleged that Defendants falsely represented Tellabs' financial results for the fourth quarter of 2000:

> According to the plaintiffs' confidential sources, Tellabs had to lease extra storage space in January and February 2001 to accommodate the large number of returns.
>
> ***While there may be legitimate reasons for attempting to achieve sales earlier via channel stuffing, providing excess supply to distributors in order to create a misleading impression in the market of the company's financial health is not one of them.*** The complaint relies on several confidential sources to support the channel stuffing allegation. For example, one source informed class counsel that Verizon's chairman had asked Tellabs to stop providing Verizon, Tellabs's largest customer, with products that Verizon did not request or require. Given the consistency and specificity of the plaintiffs' channel stuffing allegations, the district court found, and we agree, that the amended complaint provided sufficient detail of channel stuffing to overcome the PSLRA's material falsity hurdle.

Id. at 14a (emphasis added).[7, 8]

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7. The District Court found the allegations of channel stuffing, as well as allegations of backdating sales, to be sufficiently particularized. Pet. App. B at 56a-58a. The District Court noted:

(Cont'd)

The Seventh Circuit then determined, with respect to each of the actionable misstatements, that the Complaint alleges "facts that give rise to a ***strong inference*** of scienter" (emphasis added) on the part of Notebaert and, since Notebaert was Tellabs' CEO, on the part of the Company as well:

> First, as for the TITAN 5500, the Probe Research report revealed, "in or about early 2001," that the market for the TITAN 5500 had faded. In reaction to this news, Tellabs's marketing strategy department concluded that revenue from the TITAN 5500 would decline by about $400 million. According to one confidential source, a Tellabs market analyst who worked for the company throughout the class period, internal reports

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(Cont'd)

> Plaintiffs back their contentions [of channel stuffing] with allegations supported by at least 8 separate confidential sources with personal knowledge that Tellabs provided customers with products that the customers did not want. . . . These sources corroborate each other and suggest that the information is reliable. Plaintiffs identify specific customers whom Tellabs allegedly over-inventoried, namely Telcobuy and Verizon.

Id. at 56a-57a.

8. The Seventh Circuit noted, as well, that Plaintiffs "identify a series of what turned out to be overstated revenue projections made by Tellabs, which, according to the complaint, were meant to induce investors to purchase Tellabs stock." Pet. App. A at 14a. The Seventh Circuit held that "Tellabs's warnings were not particularized enough for it to claim shelter under the PSLRA's safe harbor provision." *Id.* at 16a.

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With respect to Notebaert's awareness that the representations regarding the availability of the TITAN 6500 were false, the Seventh Circuit stated:

> According to the complaint, Notebaert made a number of false statements regarding the 6500, suggesting that it was available and being shipped, when, in fact, Tellabs did not ship a single TITAN

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> 6500 during the class period. If it is true that the TITAN 6500 was not in fact available during the class period, it is hard to accept that Notebaert's statements were simply honest mistakes. According to a Tellabs sales director, Notebaert saw weekly sales reports and production projections. Another confidential source, a former high-level sales executive, reported that Notebaert knew that "the TITAN 6500 was not ready for deployment despite Tellabs'[s] public announcements." We conclude that the plaintiffs have pleaded sufficient facts to "giv[e] rise to a ***strong inference***," 15 U.S.C. § 78u-4(b)(2), ***that Notebaert knowingly lied*** when he informed investors that the 6500 was "available now" and was "being shipped."

Id. at 24a-25a (emphasis added).

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> claimed that Notebaert "unquestionably knew" about the channel stuffing.

Id.[10] The extraordinarily detailed Complaint satisfies any Circuit's formulation of the PSLRA pleading standard.

Petitioners try to make much of the Seventh Circuit's failure to take account of purported "competing innocent inferences" to be drawn from facts alleged in the Complaint. *See, e.g.*, Pet. at 15. Yet, fairly considered, there are no competing innocent inferences to be weighed against the powerful inferences of culpability in this case. Accordingly, whether or not inferences of an innocent mental state are considered and balanced against the inferences of scienter would not affect the outcome of this case. The inferences of culpability are not only the most plausible or the stronger inferences to be drawn here, they are the ***only*** inferences.

Petitioners' argument that "the record revealed no apparent motive for Notebaert to engage in fraud . . . or any benefit either to him or the company" (Pet. at 15) defies common sense. Notebaert, whose livelihood and business reputation depended on the success of the Company, no doubt was extremely concerned with its well-being. The public revelation of significant problems affecting Tellabs' key products, including that one of its most important new products, the TITAN 6500, was not ready for release, surely would have jeopardized the Company's performance and prospects in a highly competitive and troubled market.

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10. The Seventh Circuit further determined: "since the allegedly overstated revenue projections rest on the company's statements that its products were doing better than they actually were, the scienter for those alleged misrepresentations serves as sufficient circumstantial evidence of scienter here." Pet. App. A at 25a-26a.

Notebaert's natural desire to protect his Company from the adverse effects of publicizing that the products on which its fortunes depended were not selling and did not work makes complete sense. *See Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 656 (8th Cir. 2001) ("common sense would suggest that [defendant's desire to maintain company's profitability or credit rating] may be the very motives that prompt many cases of deceptive misstatements").[11]

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Nor do Tellabs' announcements on April 6 and April 18, 2001, in which the Company, among other things, modified

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11. No inference adverse to Respondents should be drawn from the fact that Notebaert did not risk his reputation, property, or liberty by not engaging in illegal insider selling of Tellabs stock while in possession of material nonpublic information.

12. In addition, because Respondents did not have access to discovery when drafting the Complaint, it would be unfair to require them to know or speculate as to what was in Petitioners' minds.

13. *See, e.g., Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 343-44 (4th Cir. 2003); *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1095 (10th Cir. 2003); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 38 (1st Cir. 2002); *Green Tree*, 270 F.3d at 653-54; *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 407-09 (5th Cir. 2001); *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 76-77 (2d Cir. 2001); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 548, 550 (6th Cir. 2001); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1283 (11th Cir. 1999); *In re Advanta Sec. Litig.*, 180 F.3d 525, 535 (3d Cir. 1999).

its previous guidance, give rise to an innocent inference. Tellabs revised its estimates of 2001 performance only when the release of disappointing first quarter 2001 results forced its hand. Moreover, at the very same time Tellabs modified its guidance, Notebaert falsely assured analysts that Tellabs was still on track to recognize TITAN 6500 revenue in the second quarter: "[W]e should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong." The Seventh Circuit found these statements actionable. Pet. App. A at 13a.

Likewise, Tellabs' attempt to accelerate sales by channel stuffing can hardly be viewed as innocent in light of the Complaint's allegations that, according to one confidential source (a high-level Tellabs sales executive), Tellabs employees actually fabricated purchase orders for products customers had not ordered (Pet. App. A at 25a); that, according to another source, Tellabs sent unwanted TITAN 5500s to such customers as Verizon and Telcobuy (Pet. App. B at 56a-57a); and that the Chairman of Verizon, Tellabs' largest customer, even called Tellabs to complain about channel stuffing (Pet. App. A at 14a). Yet another source, a Tellabs marketing manager, revealed that, to pull TITAN 5500 sales to such large customers as SBC and Sprint from the first quarter 2001 into the fourth quarter 2000, Tellabs backdated sales. Pet. App. B at 58a.

In short, considered individually and cumulatively, the facts alleged compel a powerful inference of scienter that would satisfy even the most stringent reading of the PSLRA. The Complaint supports an inescapable inference that Petitioner Notebaert, who was responsible for managing the Company at the very highest level, was fully aware that the very serious problems affecting sales of Tellabs' core products jeopardized

the Company's overall performance and prospects. *See, e.g.*, *Kinder-Morgan*, 340 F.3d at 1106; *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.*, 320 F.3d 920, 943 n.21 (9th Cir. 2003); *Zonagen*, 267 F.3d at 424-25; *Advanta Corp.*, 180 F.3d at 539.

CONCLUSION

The petition for a writ of certiorari should be denied.

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No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD C. NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITIONERS' REPLY BRIEF

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IN THE

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PETITIONERS' REPLY BRIEF

Respondents have all but conceded that there is a deep split of authority concerning both the standard for pleading scienter under the PSLRA, and the ability of a court to take into account at the pleading stage inferences unfavorable to the plaintiff. Respondents have devoted but a single sentence to the split. In that sentence, respondents assert that "much" of what petitioners have said about the disparate approaches prevailing in the courts of appeals amounts to "differences in semantics, not substance." Opp. 1. But despite the availability of ample space in their brief, respondents make no effort to reconcile the different legal tests described in the petition. Pet. 3-5, 19-26.

The reason is simple: the different tests are substantive, not merely semantic. That is why the lower courts, including the Seventh Circuit here, have acknowledged that different courts

have interpreted the strong inference requirement differently, and have explicitly disagreed among themselves as to the appropriate legal standard and the role of unfavorable inferences. Pet. App. 20a-21a. As shown in the Petition, those differences are outcome determinative, which is why two well respected industry groups have recognized that the split is real and meaningful. Amicus Br. of SIFMA & Chamber of Commerce at 3-4. Only this Court can provide a uniform standard for determining whether a complaint has alleged a "strong inference of scienter."

Respondents ignore the pressing need for this Court to adopt a uniform interpretation of the "strong inference" standard, and rest their Opposition on the proposition that this is an inappropriate case for this Court to clarify the law because the facts of this case "satisf[y] any formulation of the PSLRA pleading requirements." Opp. 1. In fact, respondents' own discussion of why their allegations satisfy the "strong inference" standard merely mimics that of the Seventh Circuit, and suffers from the same defect. Both respondents and the Seventh Circuit refuse even to consider the innocent inferences that may be drawn from the record. Whether a court should consider such innocent inferences at all, and, if so, whether a complaint survives only if the inference of scienter is the most plausible is precisely the question that demands this Court's attention. Respondents' refusal even to acknowledge that important question cannot disguise the fact that this case presents an excellent vehicle for addressing it.

1. There is a mature circuit split regarding whether and to what extent inferences of a defendant's innocent mental state should be considered under the PSLRA's "strong inference of scienter" standard. Respondents nowhere dispute that the circuits have articulated different formulations for how district courts should evaluate whether a complaint adequately alleges facts that give rise to a "strong inference" that a defendant acted with scienter. The First, Fourth, Sixth and Ninth

Circuits have stated not only that innocent inferences should be considered, but that the inference of scienter must be the "most plausible," *i.e.*, more plausible than any innocent inference, for a complaint to survive. Pet. 19-20, *citing In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2005), *Ottman* v. *Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 350 (4th Cir. 2003), *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002), *Helwig* v. *Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001). By contrast, the Tenth and Eighth Circuits forbid direct comparison of the strength of competing innocent and culpable inferences, and have expressly rejected the "most plausible" standard. Instead, these courts have instructed that the strength of innocent inferences should be considered only as a factor in determining whether an inference of scienter meets some threshold standard of strength. Pet. 20-21, *citing Pirraglia* v. *Novell, Inc.*, 339 F.3d 1182, 1187-88 (10th Cir. 2003), *Florida State Bd. of Admin.* v. *Green Tree Fin. Corp.*, 270 F.3d 645, 665-67 (8th Cir. 2001). By further contrast, the Seventh Circuit, in the case under review, watered down the Tenth Circuit's standard, holding that a complaint should survive "if it alleges facts from which ... a reasonable person *could* infer that the defendant acted with the required intent," Pet. App. 20a (emphasis added), and refused even to consider the innocent inferences that emerged from the record.[1]

Respondents treat these different approaches as non-substantive, semantic differences. Opp. 1. The courts of appeals disagree. The Ninth Circuit, when considering what role innocent inferences should play in evaluating a complaint, chose expressly to align itself with the Sixth

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[1] The Seventh Circuit's standard is also noticeably weaker than that employed by the Second and Third Circuits, which have not permitted complaints to survive based on the kind of ambiguous allegations of scienter that the Seventh Circuit accepted. Pet. 23-24, *citing Novak* v. *Kasaks*, 216 F.3d 300, 308-09 (2d Cir. 2000), *GSC Partners CDO Fund* v. *Washington*, 368 F.3d 228, 239-45 (3d Cir. 2004).

Circuit's "'most plausible of competing inferences'" test. *Gompper*, 298 F.3d at 897, *citing Helwig*, 251 F.3d at 553. The Eighth Circuit, on the other hand, has specifically chosen to back away from any suggestion that it had adopted that standard. *In re K-Tel Int'l Sec. Litig.*, 300 F.3d 881, 889 n.6 (8th Cir. 2002). The Tenth Circuit expressly considered whether to adopt the "'most plausible of competing inferences'" standard, and chose to "reject the position of the Sixth Circuit." *Pirraglia*, 339 F.3d at 1188, *citing Helwig*, 251 F.3d at 553. At the same time, the Tenth Circuit agreed with the Ninth Circuit's view expressed in *Gompper* that a court must consider innocent inferences when evaluating whether a complaint adequately alleges a strong inference of scienter. *Pirraglia*, 339 F.3d at 1187-88. Respondents provide no basis for their view that the courts of appeals have been confronting, sometimes rejecting and other times accepting, each other's views for no substantive reason. As the Second Circuit has rightly observed, the role of innocent inferences "raises serious concerns." *Press* v. *Quick & Reilly, Inc.*, 218 F.3d 121, 130 (2d Cir. 2000).

Moreover, the courts of appeals have made clear the substantive reasons that animated their choice of a particular standard. The Tenth Circuit, rejecting the "most plausible of competing inferences" standard, explained that its decision was driven by concern that weighing competing inferences is the province of the factfinder. *Pirraglia*, 339 F.3d at 1188. The Seventh Circuit went even further and argued that to avoid the need to inquire into a potential Seventh Amendment violation, courts should be precluded from considering innocent inferences altogether. Pet. App. 20a-21a. According to the Seventh Circuit, if a "reasonable person *could* infer that the defendant acted with the required intent," then the complaint should survive. *Id.* at 20a (emphasis added). The Seventh Circuit's test is materially weaker even than of the Tenth Circuit's, which requires a plaintiff to plead facts that "*would convince* a reasonable person that the defendant knew

a statement was false or misleading." *Adams* v. *Kinder-Morgan, Inc.*, 340 F.3d 1083, 1105 (10th Cir. 2003) (emphasis added).

The difference between whether an inference could possibly be drawn (the Seventh Circuit's test) and whether that same inference would be reasonably convincing (the Tenth Circuit test) or the most plausible (the Sixth Circuit test) goes to the substantive core of the PSLRA's "strong inference" standard. Merely requiring, as the Seventh Circuit does, that the inference of scienter be possible amounts to the traditional pleading rule that all inferences from the facts alleged should be drawn in favor of the plaintiffs. As the Ninth and Tenth Circuits have expressly recognized, to take that approach under the PSLRA's strong inference standard would all but eviscerate Congress's effort to raise the pleading standard. *Gompper*, 298 F.3d at 896; *Pirraglia*, 339 F.3d at 1187-88. This case, in which alternative innocent inferences were simply ignored by the court of appeals, goes to the heart of whether the "strong inference" standard will be interpreted in a way that advances or frustrates its purpose.

2. Respondents' discussion of the Seventh Circuit standard begs the question. Respondents argue that the Seventh Circuit acknowledged the PSLRA's "strong inference" requirement and recognized that a "heightened pleading standard" was intended. Opp. 1-4. This effort to characterize the Seventh Circuit's opinion as uncontroversial attempts to skirt the issue presented by the Petition. Respondents conclude that the Seventh Circuit correctly applied the "strong inference" standard merely because it repeatedly used the phrase "strong inference" in its opinion. *Id.* at 4 (counting usage of the phrase "strong inference"). But use of the language of the statute only begs the question of what standard is required by those words. Nobody can doubt that the PSLRA uses the phrase "strong inference." The dispute of authority that has arisen is, of course, not over what the words *are*, but rather over what they *mean*. The phrase is not self-interpreting; it

requires judicial exposition. And Congress clearly intended a uniform national standard, not the varying interpretations prevailing today.

Even though respondents ignore the dispute among the circuits over the interpretation of the "strong inference" standard, the Seventh Circuit did not. The Seventh Circuit expressly rejected the "most plausible of competing inferences" test adopted by the First, Fourth, Sixth and Ninth Circuits. Pet. App. 20a-21a. It did so for the specific reason that it thought that test raised concerns under the Seventh Amendment. *Id.* at 20a. The Seventh Circuit's discussion of what "strong inference" has meant to other courts, along with its own contribution to that debate, belies respondents' suggestion that merely uttering the phrase is enough.

How the Seventh Circuit actually evaluated the record in this case reveals clearly its lenient version of the "strong inference" standard. As explained in the Petition, the Seventh Circuit refused to evaluate the complaint in light of the innocent inferences that were apparent from the record, and instead held that a "complaint [should] survive if it alleges facts from which ... a reasonable person could infer that the defendant acted with the required intent." Pet. App. 20a; Pet. 13-15. That is a more lax standard than that adopted by any other circuit. But even if it were not a uniquely weak standard, even if it were, for example, a faithful application of the Tenth Circuit standard (which it is not), there would still remain a deep split of authority requiring this Court's attention. Respondents simply ignore this fact.

3. This is an excellent vehicle for this Court to provide a uniform "strong inference" standard. Respondents devote the bulk of their Opposition to explaining why their complaint would survive under any interpretation of "strong inference." Their explanations simply ignore the question presented by the split of authority: whether and how a court should consider innocent inferences that may be drawn from the facts in a federal securities fraud complaint. When one focuses on that

issue, it becomes clear that this case sharply presents the question presented in the Petition.

Respondents emphasize their allegations that certain of Notebaert's public statements were false. Opp. 4-8. But this entirely misses the mark. For present purposes, petitioners do not dispute that the complaint adequately alleges that certain statements, *e.g.*, about the strength of demand for the Titan 5500, turned out to be false. *Id.* at 5-7. But alleging that statements were uttered which turned out to be false is not enough to establish Notebaert's liability under the federal securities laws. The statements must have been known by him to be false when made, or made with reckless indifference to the truth at the time. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214 (1976). The element of scienter, which is the focus of the Petition, is critical to ensure that our capital markets do not become bogged down in vexatious litigation, and that corporate executives are encouraged to provide information freely to the public concerning their companies. Amicus Br. of SIFMA & Chamber of Commerce 7-9. That is why courts recognize that allegations in a complaint that statements by defendants turned out to be false tell us nothing about whether a given defendant acted with scienter. Pet. App. 16a (stating that the allegations of actionable false statements "will not affect the ultimate outcome of this case" unless the complaint also adequately pleads scienter). Indeed, the fact that this Court may assume that certain statements within the class period were false only properly focuses attention on the actual issue presented: whether the complaint alleges facts giving rise to a "strong inference" that any alleged false statement by Notebaert was made by him with scienter.

Respondents do not turn to that question until page 9 of their 15 page brief. Yet even when (finally) devoting attention to the "strong inference" standard, respondents fail to engage meaningfully the central issue: whether and how a court should consider inferences that the defendant acted with an innocent mental state that may be drawn from the record.

Respondents' "analysis" consists largely of block quotations from the Seventh Circuit's decision. Opp. 9-12. But the problem emphasized by the Petition is that the Seventh Circuit chose not to consider inferences of an innocent mental state that could be drawn from the facts. Pet. 13-15, 26-28. Repeating what the Seventh Circuit said is simply non-responsive. What matters is whether the Seventh Circuit properly chose to look only to the inferences that "could" be drawin in respondents' favor in determining whether a "strong inference" of scienter had been alleged.

Respondents claim that "fairly construed, there are no competing innocent inferences to be weighed against the powerful inferences of culpability in this case." Opp. 12. Respondents' meager effort to support that assertion ignores the substantial basis for inferring innocence on this record.

For example, respondents' effort to deny that the April 6 and April 18 downward guidance revisions provide a basis for an innocent inference reflects their refusal (like the Seventh Circuit) even to engage innocent possibilities. Respondents argue that those revisions were "forced" by "the release of disappointing first quarter 2001 results." *Id.* at 14. But the heart of respondent's complaint is that needed revisions to guidance were deliberately not made until June 19, 2001. Respondents do not even try to explain why Notebaert, in the middle of an alleged seven-month fraud, would be "forced" to speak truthfully (even in part) about guidance revisions for the remainder of the year (lowering revenue projections by about 20%) by supposedly disappointing financial results in the first quarter of 2001. Much less do respondents attempt to explain what kind of facts could point to an innocent mental state if truthful statements modifying projections downward in response to truthful reports of financial results do not qualify.

The complete absence of any plausible motive for Notebaert to commit the alleged fraud is another significant "competing innocent inference," and respondents' response is similarly

weak.[2] The allegations of the complaint concern a circumscribed, seven-month period, ending when the company itself announced revisions to its guidance. There is no allegation that Notebaert sold stock during that period, and no allegation that the company benefited financially during that period. Yet respondents insist there was a motive because Notebaert would have wanted to protect his company from "the adverse effects of publicizing that" its products were not selling "in a highly competitive and troubled market." Opp. 12-13. But respondents never explain why Notebaert's supposed desire to protect his company from the adverse effects of the truth would suddenly evaporate a mere seven months after it formed, or why the "truth" after seven months would be any less harmful than the "truth" disclosed earlier. The innocent inference is powerful, even if respondents (and the Seventh Circuit) refuse to acknowledge it.

Respondents' claim that there are no innocent inferences to be drawn from this record is, in fact, a disguised assertion that courts should not engage innocent inferences at all. Only by refusing even to consider innocent inferences could respondents (following the Seventh Circuit) adopt an approach that rewards their ambiguous pleading with respect to both the Probe Research report and the alleged channel stuffing. See Pet. 27-28. Respondents emphasize their allegation that channel stuffing occurred, including illegitimate channel stuffing. Opp. 14. But, as below, respondents ignore the fact that they defined channel stuffing to include innocent conduct as well, and never alleged that Notebaert knew of or participated in any *illegitimate* channel stuffing. And, conspicuously, the paragraph in the Opposition describing

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[2] Respondent's assertion that the lack of motive allegations is unimportant because motive is not an essential element of a § 10(b) claim misses the point. Opp. 13. While motive is not an essential element of the claim, the presence or absence of allegations of motive are useful indications of the presence or absence of scienter. Pet. 24 *citing Kalnit* v. *Eichler*, 264 F.3d 131, 142 (2d Cir. 2001); *GSC Partners*, 368 F.3d at 238.

respondents' allegations of illegitimate channel stuffing makes no mention of Notebaert at all. It is respondents' own ambiguous pleading that raises the inference that Notebaert was unaware of any illegitimate channel stuffing, whether respondents acknowledge it or not.

In the end, pretending that, regardless of the legal standard, the record provides no basis for inferring that Notebaert acted with an innocent mental state does not make it so. To the contrary, the legal standard applied is dispositive here. The question of whether and how to consider innocent inferences that may be drawn from the record when determining whether a complaint adequately pleads facts giving rise to a "strong inference" of scienter is well presented by this case. That question has widely divided the courts of appeals. Granting the Petition will enable this Court to provide the uniform answer that Congressional policy and the proper functioning of our capital markets demand.

CONCLUSION

For the foregoing reasons, and those stated in the Petition, a writ of certiorari should be granted.

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On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

JOINT APPENDIX

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CERTIORARI GRANTED JANUARY 5, 2007

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NOTICE

The following documents have been omitted in the printing of this Joint Appendix. They may be found in the Petitioners' Appendix to the 06-484 Petition For A Writ Of Certiorari at the following pages.

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Makor Issues & Rights, Ltd. v. *Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006) 1a-27a

Johnson v. *Tellabs, Inc.*, 303 F. Supp. 2d 941 (N.D. Ill. 2004) 28a-79a

Johnson v. *Tellabs, Inc.*, 262 F. Supp. 2d 937 (N.D. Ill. 2003) 80a-117a

UNITED STATED DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS

[Filed: 06/18/2002]

CIVIL DOCKET FOR CASE #: 1:02-cv-04356

THOMAS JOHNSON, individually and on behalf of all others similarly situated, MAKOR ISSUES & RIGHTS, LTD.
Plaintiffs,

v.

TELLABS, INC.
Defendant.

RELEVANT DOCKET ENTRIES

DATE	NO.	PROCEEDINGS
06/18/2002	1	COMPLAINT (Attachment(s); jury demand - Civil cover sheet - Appearance(s) of Steven G. Schulman, Marvin A. Miller, Samuel H. Rudman, Jennifer Winter Sprengel, Lori Ann Fanning, Nadeem Faruqi and Guri Ademi as attorney(s) for plaintiff (no summons(es) (Documents: (1-1 through 1-3)) (gcy) (Entered: 06/19/2002)
		* * * *
09/26/2002	34	MINUTE ORDER of 9/26/02 by Hon. Amy J. St. Eve : Makor Issues' motion to serve as lead plaintiff is granted. In addition, Makor Issues' motion to approve the selection of Millberg Weiss Bershad Hynes and Lerach LLP as lead counsel and Miller Faucher and Cafferty LLP as liaison counsel is also granted. Plaintiffs are to file their amended

DATE	NO.	PROCEEDINGS
		consolidated complaint by 11/12/02. Entered Memorandum Opinion and Order. Mailed notice (yp) (Entered: 09/27/2002)
		* * * *
12/03/2002	40	CONSOLIDATED AMENDED CLASS ACTION COMPLAINT [1-1] by plaintiff; jury demand terminating plaintiff Makor Issues &, unknown John Gambino, unknown Manuel Bordelove, unknown Frederick Haddad, unknown Leo Nittskoff, unknown Shelomoh Sameyah, unknown Sabihch Sameyah, unknown Philip Schriger, unknown Teddy Wallach; adding John Vaughn, Robert W Pullen, Joan E Ryan, Brian Jackman, J Thomas Gruenwald, John C Kohler, William F Souders, Catherine Kozik (Attachments); Notice. (jmp) (Entered: 12/05/2002)
		* * * *
01/17/2003	47	MOTION by defendants Tellabs Inc, Michael J Birck, Richard C Notebaert, John Vaughn, Robert W Pullen, Joan E Ryan, Brian Jackman, J Thomas Gruenwald, John C Kohler, William F Souders, Catherine Kozik to dismiss complaint ; Notice of motion; Memorandum in Support (eav) (Entered: 01/23/2003)
		* * * *
01/17/2003	49	APPENDIX filed by defendants Tellabs Inc, Michael J Birck, Richard C Notebaert, John Vaughn, Robert W Pullen, Joan E Ryan, Brian Jackman, J Thomas Gruenwald, John

DATE	NO.	PROCEEDINGS
		C Kohler, William F Souders, Catherine Kozik of materials cited in the memorandum in support of motion to dismiss [47-1] (eav) (Entered: 01/23/2003)
		* * * *
03/14/2003	51	MEMORANDUM by plaintiff in opposition to defendants' motion to dismiss the consolidated amended class action complaint [47-1] (Attachments); Notice. (ntf) (Entered: 03/17/2003)
		* * * *
04/18/2003	57	REPLY memorandum by defendants in support of defendants' motion to dismiss complaint [47-1] (Attachment). (ntf) (Entered: 04/22/2003)
		* * * *
05/19/2003	60	MINUTE ORDER of 5/19/03 by Hon. Amy J. St. Eve : Defendants' motion to dismiss R. [47-1] is granted without prejudice. Plaintiffs have until 6/27/03 to file an amended complaint consistent with the court's order. Entered Memorandum Opinion and Order. Mailed notice by judge's staff (eav) (Entered: 05/20/2003)
		* * * *
07/11/2003	63	SECOND CONSOLIDATED AMENDED CLASS ACTION COMPLAINT by plaintiff; jury demand terminating defendants Catherine Kozik, William F Souders, John C Kohler, J Thomas Gruenwald, Brian Jackman, Joan E Ryan, Robert W Pullen,

DATE	NO.	PROCEEDINGS
		Richard C Notebaert, Michael J Birck; Notice. (aga) Modified on 07/18/2003 (Entered: 07/14/2003)
		* * * *
08/27/2003	70	MOTION by defendants Tellabs Inc, Michael J. Birck, Brian Jackman, John C. Kohler, Richard C. Notebaert, Richard C. Notebaert, Robert W. Pullen, Joan E. Ryan to dismiss the second consolidated amended class action complaint ; Notice (hp) (Entered: 08/29/2003)
		* * * *
08/27/2003	72	MEMORANDUM by defendants Tellabs Inc, Michael J. Birck, Richard C. Notebaert, Robert W. Pullen, Joan E. Ryan, John C. Kohler, Brian Jackman in support of their motion to dismiss second consolidated amended class action complaint [70-1] (hp) (Entered: 08/29/2003)
		* * * *
08/27/2003	74	APPENDIX filed by defendants Tellabs Inc, Michael J. Birck, Richard C. Notebaert, Robert W. Pullen, Joan E. Ryan, Brian Jackman, John C. Kohler of materials cited in the memorandum in support of their motion to dismiss the second consolidated amended class action complaint [70-1] (Attachments). (hp) (Entered: 08/29/2003)
		* * * *

DATE	NO.	PROCEEDINGS
10/03/2003	78	OPPOSITION by plaintiffs to defendants' motion to dismiss the second consolidated amended class action complaint [70-1]; Notice. (hp) (Entered: 10/06/2003)
		* * * *
11/07/2003	85	CORRECTED REPLY MEMORANDUM by defendants Tellabs Inc, Michael J. Birck, Richard C. Notebaert, Robert W. Pullen, Joan E. Ryan, Brian Jackman, John C. Kohler in support of their motion to dismiss second consolidated amended class action complaint [83-1] (Attachment). (hp) (Entered: 11/13/2003)
		* * * *
11/20/2003	87	MOTION by plaintiffs for leave to file supplemental authority in opposition to defendants' motions to dismiss (Attachment); Notice (hp) (Entered: 11/24/2003)
11/21/2003	88	MINUTE ORDER of 11/21/03 by Hon. Amy J. St. Eve : Plaintiff's motion for leave to file supplemental authority in opposition to defendants' motions to dismiss is granted. [87-1] Mailed notice (hp) (Entered: 11/24/2003)
		* * * *
12/08/2003	89	MOTION by plaintiffs for leave to file additional supplemental authority in opposition to defendants' motions to dismiss (Attachment); Notice (hp) (Entered: 12/11/2003)

DATE	NO.	PROCEEDINGS
12/11/2003	90	MINUTE ORDER of 12/11/03 by Hon. Amy J. St. Eve : Plaintiff's motion for leave to file additional supplemental authority in opposition to defendants' motions to dismiss is granted. [89-1] Mailed notice (hp) (Entered: 12/11/2003)
		* * * *
02/19/2004	92	MINUTE ORDER of 2/19/04 by Hon. Amy J. St. Eve : Defendants' motion to dismiss is granted. [70-1] Status hearing set for 02/25/04 is stricken. Any other pending dates are stricken. Any other pending motions are denied as moot. (Entered Memorandum Opinion and Order.) terminating case Mailed notice (hp) (Entered: 02/20/2004)
02/19/2004	93	ENTERED JUDGMENT (hp) (Entered: 02/20/2004)
03/04/2004	94	RULE 59(e) MOTION by defendants Michael J. Birck, Richard C. Notebaert, Robert W. Pullen, Joan E. Ryan, John C. Kohler, Brian Jackman to alter or amend judgment to clarify certain of the findings in the Court's February 19, 2004 memorandum opinion and order ; Notice (hp) (Entered: 03/10/2004)

DATE	NO.	PROCEEDINGS
03/09/2004	95	MINUTE ORDER of 3/9/04 by Hon. Amy J. St. Eve : Defendants' Rule 59(e) motion to alter [94-1] or amend judgment to clarify certain of the findings in the Court's February 19, 2004 memorandum opinion and order is granted. [94-2]. (See reverse of minute order.) Mailed notice (hp) (Entered: 03/10/2004)
03/18/2004	96	NOTICE OF APPEAL by lead plaintiff Makor Issues &, et al from motion minute order [95-1], judgment entered [93-1] order Memorandum Opinion and Order [92-1] order terminating case [92-2] motion minute order [92-3], Scheduling order Entered Memorandum Opinion and Order [60-1] motion minute order [60-2] (FEE PAID); Notice (mak) Modified on 03/19/2004 (Entered: 03/19/2004)
		* * * *
04/02/2004	99	TRANSCRIPT of proceedings for the following date(s): 03/09/04 and 02/11/04 appeal [96-1] Before Honorable Any J. St. Eve (2 Vols: 99-1 thru 99-2) (hp) (Entered: 04/05/2004)
		* * * *
07/19/2006	101	MANDATE of USCA dated 1/25/06 regarding notice of appeal, 96 ; USCA No. 04-1687 ; We affirm in part and reverse in part the judgment of the district court and remand for further proceedings consistent with this opinion. Assess costs against Tellabs. (mjc,) (Entered: 07/21/2006)

DATE	NO.	PROCEEDINGS
07/19/2006	102	OPINION from the USCA for the 7th Circuit; Argued 1/21/05; Decided 1/25/06 in USCA case no. 04-1687. (mjc,) (Entered: 07/21/2006)

* * * *

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

[Filed 3/19/04]

Court of Appeals Docket #: 04-1687

MAKOR ISSUES & RIGHTS, *et al.*,
Appellants,

v.

TELLABS INCORPORATED, *et al.*,
Appellees.

RELEVANT DOCKET ENTRIES

DATE	PROCEEDINGS
3/19/04	Private civil case docketed. [04-1687] [1719763-1] Transcript information sheet due 3/29/04. Appellant's brief due 4/28/04 for Makor Issues & Right, for Chris Broholm, for Richard LeBrun, for David Leehey, for Patricia Morris. Docketing Statement due 3/25/04. (hudk)
	* * * *
5/21/04	Filed 15c appellant's brief by Makor Issues & Right, Chris Broholm, Richard LeBrun, David Leehey, Patricia Morris. Disk filed. CORRECTED, per order of 7/29/04. [04-1687] [0-0] (cerr)
5/21/04	Filed 10c appendix by Appellant Makor Issues & Right, Appellant Chris Broholm, Appellant Richard LeBrun, Appellant David Leehey, Appellant Patricia Morris . [04-1687] [1740216-1] (cerr)
	* * * *

DATE	PROCEEDINGS
7/2/04	Filed 15c appellee's brief by Tellabs Incorporated, Michael J. Birck, Richard C. Notebaert, Robert W. Pullen, Joan E. Ryan. Electronically Transmitted. [04-1687] [0-0] (josh)
	* * * *
7/29/04	Filed 15c appellant's CORRECTED brief by Makor Issues & Right, Chris Broholm, Richard LeBrun, David Leehey, Patricia Morris, per order. Disk filed. [04-1687] [0-0] (matt)
8/2/04	Filed 15c appellant's reply brief by Makor Issues & Right, Chris Broholm, Richard LeBrun, David Leehey, Patricia Morris. Disk filed. [04-1687] [0-0] (matt)
	* * * *
11/3/04	Filed Appellant Makor Issues & Right, Appellant Chris Broholm, Appellant Richard LeBrun, Appellant David Leehey, Appellant Patricia Morris Citation of Additional Authority, per CR 28(e). [04-1687] [1793863-1] (tiff)
11/15/04	Filed Appellee Tellabs Incorporated, Appellee Michael J. Birck, Appellee Richard C. Notebaert, Appellee Robert W. Pullen, Appellee Joan E. Ryan Citation of Additional Authority, per CR 28(e). Dist. [04-1687] [1798534-1] (amyd)
	* * * *
1/19/05	Filed Appellee Tellabs Incorporated, Appellee Michael J. Birck, Appellee Richard C. Notebaert, Appellee Robert W. Pullen, Appellee Joan E. Ryan Citation of Additional Authority, per CR 28(e). Dist. [04-1687] [1818296-1] (nath)

DATE	PROCEEDINGS
1/21/05	Case heard and taken under advisement by panel: Circuit Judge Kenneth F. Ripple, Circuit Judge Diane P. Wood, Circuit Judge Diane S. Sykes. [04-1687] [1818518-1] (cal)
1/21/05	Case argued by David F. Graham for Appellee Joan E. Ryan, Appellee Robert W. Pullen, Appellee Richard C. Notebaert, Appellee Michael J. Birck, Appellee Tellabs Incorporated, Arthur R. Miller for Appellant Patricia Morris, Appellant David Leehey, Appellant Richard LeBrun, Appellant Chris Broholm, Appellant Makor Issues & Right . [04-1687] [1719763-1] (cal)
1/21/05	Filed Appellant Makor Issues & Right, Appellant Chris Broholm, Appellant Richard LeBrun, Appellant David Leehey, Appellant Patricia Morris Citation of Additional Authority, per CR 28(e). Dist. [04-1687] [1819138-1] (nath)
3/9/05	Filed Appellant Makor Issues & Right, Appellant Chris Broholm, Appellant Richard LeBrun, Appellant David Leehey, Appellant Patricia Morris Citation of Additional Authority, per CR 28(e). Dist. [04-1687] [1835717-1] (amyd)
3/16/05	Filed Appellee Tellabs Incorporated, Appellee Michael J. Birck, Appellee Richard C. Notebaert, Appellee Robert W. Pullen, Appellee Joan E. Ryan Citation of Additional Authority, per CR 28(e). Dist. [04-1687] [1839274-1] (nath)

DATE	PROCEEDINGS
1/25/06	Filed opinion of the court by Judge Wood. AFFIRMED in part, REVERSED in part and REMANDED for further proceedings consistent with this opinion. Circuit Judge Kenneth F. Ripple, Circuit Judge Diane P. Wood, Circuit Judge Diane S. Sykes. [04-1687] [1719763-1] (fern)
1/25/06	ORDER: Final judgment filed per opinion. With costs: Assess costs against Tellabs. [04-1687] [1947562-1] (fern)
2/8/06	Filed 30c Petition for Rehearing and Petition for Rehearing Enbanc and 30c of separate appendix by Appellee Tellabs Incorporated, Appellee Michael J. Birck, Appellee Richard C. Notebaert, Appellee Robert W. Pullen, Appellee Joan E. Ryan. Dist. [04-1687] [1953267-1] (fern)
	* * * *
5/3/06	Filed 30c (Opposition) Answer of Appellant Makor Issues & Right, Appellant Chris Broholm, Appellant Richard LeBrun, Appellant David Leehey, Appellant Patricia Morris to Petition for Rehearing and Petition for Rehearing Enbanc. Dist. [04-1687] [1982105-1] (amyd)
7/10/06	ORDER: Appellee Tellabs Incorporated, Appellee Michael J. Birck, Appellee Richard C. Notebaert, Appellee Robert W. Pullen, Appellee Joan E. Ryan Petition for Rehearing and Petition for Rehearing Enbanc is DENIED. [04-1687] [1953267-1] (Note: This order issued as part of an Order Modifying the Opinion) (amyd)

DATE	PROCEEDINGS
7/10/06	ORDER: The opinion of this Court issued on 1/25/06 is MODIFIED as follows: The first full paragraph on page 28 of the slip of the opinion is deleted and replaced with the following: The plaintiffs also pleaded a claim against Birck for insider trading. A private cause of action exists under 20A of the Securities Exchange Act against persons who purchase or sell a security "while in possession of material, nonpublic information." See 15 U.S.C. 78t-l(a). To create potential liability under 20A, the plaintiffs must prove an independent violation of "this chapter or the rules or regulations thereunder." Id. In other words, 20A claims are "derivative, requiring proof of a separate underlying violation of the Exchange Act.["] Advanta Corp., 180 F.3d at 541. At this point in the litigation, we have affirmed the dismissal of the underlying securities fraud claims pleaded directly against Birck. He still faces liability, but solely as a control person under 20(a). Whether 20(a) control-person liability standing alone can serve as the "separate underlying violation" required for 20A insider trading is an open question of law and raises an important issue of statutory interpretation that should not be decided in a vacuum. No party in this litigation has provided more than cursory briefing of this issue, and therefore we take no position on its resolution, leaving it for further factual and legal development during the course of the litigation. [04-1687] [1719763-1] (Note: This order also issued as a part of En Banc Petition for Rehearing Denial Order) (amyd)

DATE	PROCEEDINGS
7/18/06	MANDATE ISSUED AND ENTIRE RECORD RETURNED. (Contents returned: 4 vol. pleadings; 6 vol. loose pleadings; 2 vol. transcripts.) [04-1687] [1719763-1] (kare)
10/10/06	Filed notice from the Supreme Court of the filing of a Petition for Writ of Certiorari. Supreme Court Case No.: 06-484. [04-1687] [2033533-1] (hard)

News Release

FOR IMMEDIATE RELEASE
March 7, 2001

Tellabs updates guidance for first quarter and full year
Company closes acquisition of Future Networks

Lisle, Ill.—Tellabs announced today that it is lowering its revenue and earnings per share expectations for the first quarter 2001. Tellabs projects first quarter sales in the range of $830 million to $865 million, compared with prior guidance of $865 million to $890 million. The company projects earnings per share in the range of 35 cents to 38 cents, compared with prior guidance of 39 cents per share.

The new guidance stems from continuing below-trend growth in Tellabs' CABLESPAN® business. In addition, the company is unable to recognize revenue from shipments of its new TITAN® 6500 system in the first quarter as originally anticipated, but expects to recognize TITAN 6500 system revenues in the second quarter. Growth in Tellabs' core optical networking business remains strong.

Tellabs expects earnings per share for the year to be in the range of $2.13 to $2.17, compared with prior guidance of $2.17 per share. Tellabs expects revenues for the year to be in the range of $4.35 billion to $4.4 billion, compared with prior guidance of $4.4 billion.

"Given the strong acceptance of the new TITAN 6500, we continue to target 30 percent growth in revenue and earnings for the year," said Richard C. Notebaert, Tellabs president and CEO. "Demand for our new products is strong, and I am confident we have the right set of solutions to help our customers build tomorrow's converged networks."

Tellabs also announced it closed its acquisition of Future Networks, Inc., a leader in standards-based voice and cable modem technology. Tellabs paid approximately $133 million

in cash to acquire the stock of Future Networks, significantly lower than the previously announced purchase price. Approximately $35 million of the purchase price is tied to Future Networks achieving product development milestones. Goodwill related to the acquisition will dilute earnings by 4 cents in 2001 and 5 cents in 2002. Excluding goodwill, the Future Networks acquisition is expected to break even in 2001 and add to earnings in 2002.

Simultaneous Webcast and Teleconference—Tellabs will host a teleconference at 4:15 p.m. Central time on Wednesday, March 7, 2001 to discuss first-quarter guidance and expectations for 2001. The teleconference call-in number is 212-346-0102. Internet users can hear a simultaneous live webcast of the teleconference at www.tellabs.com. A taped replay of the call will be available for 48 hours, beginning at 6:15 p.m. Central time, at 800-633-8284. Outside of the United States, dial 858-812-6440. When prompted, enter the Tellabs reservation number: 18207400.

Tellabs designs, manufactures, markets and services optical networking, next-generation switching and broadband access solutions. The company also provides professional services that support its solutions. Tellabs' products and services are used worldwide by the providers of communications services. Its stock is listed on the NASDAQ stock market (TLAB).

Forward-Looking Statements—This news release contains forward-looking statements that involve risks and uncertainties. Actual results may differ from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, risks associated with introducing new products, entering new markets, availability of resources, competitive response, and economic changes impacting the telecommunications industry. The company undertakes no obligation to revise or update these forward-looking statements to reflect events or circumstances after today or to reflect the occurrence of

unanticipated events. For a more detailed description of the risk factors, please refer to the company's SEC filings.

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Tellabs Operations Inc.
Investor Relations Teleconference
March 7, 2001

Operator: Ladies and gentlemen, thank you for standing by and welcome to the Tellabs Investor Relations conference call. At this time, all participants are in a listen only mode. Later, we will conduct a question and answer session. At that time, if you have a question you will need to press the "1" followed by the "4" on your telephone. As a reminder, this conference is being recorded, Wednesday, March 7, 2001. I would now like to turn the conference over to Mr. John Springer, Director of Investor Relations for Tellabs. Please go ahead, sir.

John Springer: Thanks, Kelly. Good afternoon everyone. With me today is Tellabs' President and CEO, Dick Notebaert, Joan Ryan, Executive Vice President and CFO, and Brian Jackman, President of Global Systems and Technology. By now you have all had a chance to see the news release we issued earlier this afternoon. If not, the release is available at our website, www.tellabs.com.

Please note that in the first part of this call, unless otherwise specified, the financial details will exclude the impact of the recently closed Future Networks acquisition. Joan will address the acquisition specifically at the end of the call. Before we begin, and in keeping with the safe harbor provision of the Securities Litigation Reform Act of 1995, I would like to state that except for historical information, the following teleconference is based on preliminary financial results which are subject to further review and adjustment and contain forward-looking statements that involve risks and uncertainties. Actual results may differ from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, risks associated with introducing new products, entering new

markets, availability of resources, competitive response, and the economic conditions in the telecommunications industry.

The Company undertakes no obligation to revise or update these forward-looking statements to reflect events or circumstances after today or to reflect the occurrence of unanticipated events. For a more detailed description of the risk factors, please refer to the Company's SEC filings. With that, I will turn the teleconference over to Tellabs' President and CEO, Dick Notebaert.

Dick Notebaert: Thanks, John. Good afternoon everybody. Let me start by saying that our business is quite healthy and, in fact, most of the fundamental trends we talked about on our January call are intact. That is, let me be more detailed, demand for our core optical products or core networking products remains strong. Recovery of our managed digital network products continues. If you remember the second to third to fourth quarter trajectory of that it continues to go in the same upward direction. Interest and demand in the 6500 continues to grow. However, our CABLESPAN business is not coming back as quickly as we had anticipated. That accounts for roughly half the reduction in revenue guidance for the quarter.

In the near term our customers are turning their focus to gaining new subscribers from building new infrastructure. This environment has led us to trim our first quarter and our full year revenue estimates for CABLESPAN. When we get into Q&A we would be happy to talk about it some more. In addition to the CABLESPAN area, we are unlikely to recognize revenue from the TITAN 6000 series in the first quarter as we had originally planned. We continue to ship the 6100 and 6500 through the first quarter. We are satisfying very strong demand and growing customer demand. We are as confident as ever, that may be an understatement, about the 6500. We expect a formal announcement of a significant additional order shortly.

The combination of these two factors lead us now to project first quarter revenue in the range of $830 million to $865 million with an EPS in the range of $.35 to $.38. To put this into more perspective, we still expect revenue and EPS growth for the quarter to exceed 30%. As we move through the year we expect a strong revenue growth from the TITAN 6500 will mostly offset our revised expectations for CABLESPAN. In fact, had we been able to recognize revenue in the first quarter of the 6500 equipment we have shipped, we likely wouldn't be holding this call today. We now project revenue for the year in the $4.3 billion or $4.35 billion to $4.4 billion range and EPS of $2.13 to $2.17.

In summary, demand for our products remains strong. There is optimism around the new products that we have introduced. Tellabs will meet the adjusted revenue and earnings targets. Let me stop at this point and ask Joan to go into more detail.

Joan Ryan: Thanks, Dick. I will start with a detailed look at our updated guidance ranges for the first quarter and the full year excluding the Future Network acquisition. Let's start with the first quarter. We expect total revenue in the range of $830 to $865 million in the quarter and that represents a growth rate of 30-35% over last year's first quarter. By product area, year-over-year growth rates are as follows. We expect optical networking to grow 35-40%. Our broadband access group to grow 8-10%. Next-generation switching to be down 25-30% and our customer services area to be up 140-150%.

Operating margins are expected to range between 24-25%, which is consistent with what I talked about in January. That, of course, will be above a year ago by one to two percentage points so still a strong operating margin. EPS is expected in the range from $.35 to $.38 or 35-45% growth year-over-year excluding the impact of the Future Network acquisition.

Through the balance of the year we expect a revenue ramp from TITAN 6500 to offset more conservative expectations for CABLESPAN. Hence, our new range for 2001 EPS is $2.13 to $2.17 on revenue of $4.35 billion to $4.4 billion. We will go through a much more detailed look at full year 2001 when we report first quarter earnings next month.

Finally, as John mentioned earlier, Tellabs' acquisition of Future Networks closed on schedule last week. From a product perspective this acquisition completes Tellabs' next-generation solution for cable providers giving both existing and new customers the migration path for the delivery of voice, data, and video over a single IP-based network.

In short, we are helping our cable customers improve their profitability by both reducing their operating costs and broadening their revenue opportunities for subscribers. Despite the near term deployment pullback, the cable business remains a high growth business and Tellabs is at the forefront with a leadership position in next-generation technology.

At the same time, we are making the product attractive to a wider set of customers. At this point, CABLESPAN revenue is concentrated across a small group of very large MSO's. Adding cable data modem functionality and voice over IP expands our addressable market.

From a financial perspective, Tellabs' expects goodwill related dilution of half a cent in the first quarter, four cents per share for full year 2001, and five cents in 2002. Excluding goodwill the acquisition is essentially break-even in 2001 for Tellabs and accretive thereafter.

At this point we will open the floor to questions. We would like to keep this call to no more than 30 minutes. It is about 20-25 after so we will have time for about 20 minutes of questions. You will have ample time to ask detailed questions when we announce in April. Kelly, we are ready for the first question.

Operator: Thank you. Ladies and gentlemen, we will now begin the question and answer session. If you have a question, please press the "1" followed by the "4". You will hear a three tone prompt acknowledging your request. If your question has been answered and you would like to be removed from queue, press "1" followed by "3" on your touchtone phone. If you are using a speakerphone, please pick up the handset before pressing the numbers. One moment please for the first question.

Nikos Theodosopoulos/UBS Warburg: My question is on the 6500. Can you talk about what has been happening in terms of why the revenues are not able to be recognized? Is it timing in terms of customer's turning up the product? It sounds like your shipment rate for the quarter was high. Can you give a target for the year on what the product can contribute? I think going into the year people were looking at a wide range of numbers. Now that you have had a few weeks and a few months what is a reasonable target for the year on that product?

Dick Notebaert: A good question. I don't think we have given a target on the product or that kind of guidance yet. I will let Joan answer that if she would like. On the acceptance, under general accounting standards, the first office applications require a requisite soak period. During that soak period or test period, if you want to call it that, even though the equipment is installed not only do we do acceptance testing and work on it with customers to exercise it extensively, this is a far more detailed soak. It is an extended period of time than you have on a 5500 or some product that is already out there. Revenue recognition accounting rules require this type of *extended* acceptance process be completed for the first few systems until this "history" of acceptance is established with customers. For our first few systems it just is going to take longer.

Joan Ryan: In January we said it would represent 20% of the overall growth for the year. We will update that guidance at the end of the first quarter. It will be slightly higher than that I think in terms of the overall growth. We shipped those systems for 6500 late in the fourth quarter and so now we are looking at early in the second quarter of recognizing those. The first few systems we will be very conservative, that is our nature. We are anticipating revenue recognition here very soon.

Dick Notebaert: It is a timing issue. Once you get passed the first couple they should roll along very well.

Brian Jackman: I agree. There is nothing in the revenue recognition issue that should be construed to imply that the testing and customer acceptance of these systems are having difficulty. We see, quite frankly, very strong demand for the products. I think it is really a timing issue and if I were the god of accounting the rules would be different but I am not.

Nikos Theodosopoulos/UBS Warburg: So there is no software fix or anything like that? It is just a soaking period that is longer than you thought.

Dick Notebaert: That is right.

Brian Jackman: It is a big system to install and a big system to test. I think we are just trying to be very conservative and cautious in when we recognize the revenue regardless of when the customer sends us a check.

Dick Notebaert: There isn't any software but. I can't remember ever turning on a system in my prior life that for the first few years you didn't have a patch or something. There is nothing there that is meaningful.

Brian Jackman: We have that in the 5500.

Simon Leopold/Merrill Lynch: Can you give a bit of an update in terms of the 6700 and how you are doing on track and beta trials coming up and 4Q availability? Can you

update that and let us know if we can look for some revenue in our models this year from that?

Brian Jackman: The reason we didn't focus on it during the prepared remarks is because it doesn't have any revenue impact in this quarter, which is really the main thrust for the call. The 6700 continues to move on track and we are very encouraged by not only the development process and how the guides are going against plans but also the customer interest. We still are on track for beginning to do early customer trials in the second quarter. That will happen. The product is due to be released late in the third quarter. Therefore, while I expect we will have some shipments and maybe even customers who pay us for the product this year, whether we recognize revenue or not is probably going to be the same issue we are discussing right now because it is a large system. While we did not have meaningful revenue ever planned for this year I think we should be cautious at this time whether we recognize revenue from that particular system. That doesn't really change the guidance that Joan just gave you.

George Nodder/Deutsche Bank: The TITAN 5500, can you give us an update on how that flagship product is doing? I am assuming based on the size of number cuts that you are not seeing any weakness there at all?

Brian Jackman: We are not. We are still seeing that product continue to maintain its growth rate and is still experiencing strong acceptance. We are in the process of turning out a large number of frames we shipped in the fourth quarter and this is continuing to grow as usual. I think that is pretty much on plan.

George Nodder/Deutsche Bank: Any concerns relative to the marketplace in general? We see companies like Nortel and Cisco lowering their expectations. I am assuming you are not seeing any of those factors impacting your business that might be impacting those guys.

Dick Notebaert: We just lowered our expectations. With our customer base and the product niche we have our problems may be different. The environment from everything you guys write that I read for the service providers is one where you have to be continually watchful. We haven't gotten any indication from any of our major customers of a downturn in this segment we are in and in our niche.

Brian Jackman: We talked about CABLESPAN and the fact that Tellabs' business is heavily focused on the incumbent carriers as opposed to CLEC's. I think this year that appears to be a very good place to be and therefore we still see them spending. Everybody reads the same newspapers as you do and we do. They are looking over their shoulders to try and be cautious and not do anything dumb. In many cases our larger customers in particular are looking at this as an opportunity to capture share while there is financial uncertainty on the part of the newer carriers.

Steve Levy/Lehman Brothers: On the EPS guidance for the year, that includes the goodwill amortization you have there every quarter?

Joan Ryan: The current amortization of goodwill is included.

Steve Levy/Lehman Brothers: Okay. That new guidance of $2.12 to $2.17 doesn't include the dilution from the goodwill for Future Networks?

Joan Ryan: That is correct.

Dick Notebaert: It is $2.13. Part of the reason is the softness within CABLESPAN customers from what we have been told will continue for the next couple of quarters.

Steve Levy/Lehman Brothers: Your assumptions for CABLESPAN over the next few quarter's [sic] sounds like you don't expect much of a pickup. Do you expect more deterioration or just flat?

Dick Notebaert: It is not very good now. It is fairly flat. We have been told by customers that for the next two quarters MSO's are shifting primarily from building out infrastructure to gaining new subscribers. They are looking at it and saying they have a need to generate revenues and control their burn rate due to less availability of funding from outside sources. You look at share prices and tech covenant requirements and so I think we have a short-term pressure on them to improve their current financial performance. I say that at the same time I would tell you that we have also been told that we are extremely well positioned in this part of the market. With what we have done with the acquisition we offer the most complete solution, DOCSIS 1.1, which will improve their economics or cost per subscriber. We have over a million lines deployed. This new path product map we have given them for IP and data is very well received by all the major MSO's.

Brian Jackman: I would echo that on a couple of fronts. One is we are hearing from competitors that the customers are reacting strongly to the migration strategy we put in place for the product. The other thing is while our current large customer base is doing exactly what Dick indicated we are still continuing to see new customers and new customer opportunities particularly in Asia. While there is this adjustment and slowdown absorption of the installation base on the part of the current customers, we see rollout plans on the part of new carriers beginning to develop as well.

Joan Ryan: From a financial perspective, the weakness we talked about in CABLESPAN over the next few quarters will be offset by focused expense control along with the revenue recognition on the TITAN 6000 series. We will see that in the beginning of the second quarter and then accelerated through the year.

Dick Notebaert: CABLESPAN of all the products probably has the lowest gross margin.

Joan Ryan: Right.

Todd Kaufman/Raymond James: I am assuming a smaller contribution for newer products particularly almost no contribution from one of your lowest margin products. Why did the operating margin guidance not change? Wouldn't margin tend to look better on lower revenues?

Joan Ryan: For the year, operating margin is up ticking a bit on the new guidance we are seeing relative to what we talked about. I think also we are seeing start-ups and manufacturing related scale impacts of the new products. While we haven't realized revenue on those in the first quarter there are some things that are period costs associated with that through our cost to goods. It is assembly and test related expenses and that sort of stuff.

Dick Notebaert: I think we are being conservative in our look at this because we are introducing rolling out the 6500 and the 6700 is a very high-end product and we have to do a lot of work on that. We are taking the right approach as far as how we are looking at it even though we are very aggressively managing our costs.

Robert Tango/William Blair: In some of the guidance you gave out the optical networking division will grow 35-40% this year and next-gen switching will be down 25-30%. Both of those growth rates seem like they are adjusted slightly from Q4. Can you comment on what is happening with next-gen switching?

Joan Ryan: Actually what I quoted was first quarter. We will give more detail product group guidance on the full year when we get together a month or so from now. That whole impact is the revenue recognition of 6500 and that is the quarter. In terms of switching overall we gave it would be down 20% in the quarter vs. 25-30%. It is our switching business primarily which is an investment area for us.

Brian Jackman: The primary part of that today is echo and so the bulk of the revenue is in that area. The issue there is the migration of the technolcgy into higher-level systems as a component rather than a standalone product. That is really the major part of the revenue side of things. As Joan said, the next-generation switching area, which is an investment area, and the guidance we have given is that we really don't expect that to be a major revenue contributor until next year. This is an emerging new marketplace that is still very immature and we don't think there will be major traction in this space until 2002.

David Heger/A.G. Edwards: My question was already answered.

Tim Sanjavo/WR Hambreth: I want to follow up on the next-generation switching front. As we talk about new products and new contribution to growth, are we talking about the SALIX product at all in those types of comments? Can you give us a feel whether you are seeing any revenue there at all in the near term and what the expectations might be for contributions going forward?

Brian Jackman: We are talking about the SALIX product as part of that product area and it is the biggest piece of the next-generation switching investment area. While we are expecting revenue from that space throughout the rest of the year, I think the guidance we are trying to give is that it will be both modest and certainly not anywhere near corporate averages as far as margins. It is a new investment area for the Company.

Tim Sanjavo/WR Hambreth: Would you expect year-over-year growth in either the broadband access or next-generation switching businesses for 2001?

Dick Notebaert: Yes.

Joan Ryan: We will. I will give more detailed guidance when we get together a month or so from now.

Hillary Sweeney/Baird Benzak: Are you gaining or holding or losing market share in CABLESPAN and does it have more to do with competition or demand?

Dick Notebaert: It has nothing to do with competition. We are doing very well and very fortunate that we did the acquisition. We are holding very well. As Brian pointed out, there are other opportunities there. We are not losing to competition at all. You might occasionally see a press release or something but when it comes down to what is being shipped and what is being deployed in the field, whether in Europe or in the United States, we are doing exactly what we should be doing.

Brian Jackman: Both the relationship we have with Riverstone on an OEM basis as well as the acquisition of FNI and along with the enhancements we put into the existing platform and the installed base we have never being stronger and that is the feedback we are getting. I think it is really just an issue of customer timing. They invested very heavily in 2000 in putting their networks in place. They now want to turn on the marketing machines and fill up those types with revenue bearing services before they begin to invest again. Quite often the model is when you are building one of these networks, if you spend a lot of money on head end equipment and then begin to roll it out on a per home or per small business basis, and you go back and re-engineer the network and determine the next city or next part of the city you will market again. It is a cycle issue, which if capital were still plentiful and cheap they might invest upfront. Right now they are trying to match revenues with expenses.

Hillary Sweeney/Baird Benzak: Can you touch on European demand and also an update on TITAN products and echo cancellers?

Brian Jackman: I am confused by the question because the TITAN is not a European product line at least as of yet. We are seeing good sales in Europe. We feel strongly about Europe and the demand for the products we have like DXX and the Focus product line that comes out of Denmark. TITAN is not a major product in the European marketplace as of yet. We expect that will change by the time this year ends as we begin to rollout some additional flavors including the 6700, which will be coming up for Europe as well.

Dick Notebaert: We have had good interest from Europe in the 6700. We just did a demo in Canada with a European PTT to look at it. It will have good traction.

Joan Ryan: This will be our last question We are out of time.

Operator: I am showing no further questions at this time.

Dick Notebaert: Thank you very much Thank you everyone.

Operator: Ladies and gentlemen that does conclude your conference call for today. You may all disconnect. Thank you for participating.

News Release

FOR IMMEDIATE RELEASE
April 6, 2001

Tellabs revises first-quarter guidance

Company expects 21 percent year-over-year revenue growth

Lisle, Ill.—Tellabs today announced revised revenue and earnings per share expectations for the first quarter of 2001. Tellabs projects first-quarter sales of about $772 million, compared with prior guidance in the range of $830 million to $865 million. The company projects earnings per share of 29 cents, compared with prior guidance of 35 cents to 38 cents.

The revised guidance stems from reduced and deferred spending by major communications carriers late in the quarter. Tellabs is aggressively managing its costs and aligning its products to help carriers meet the demand for bandwidth, lower their operating costs and generate new revenue.

"The health of our business depends on the health of our customers, and we're seeing caution from them in the current economic environment," said Richard C. Notebaert, president and CEO.

Simultaneous Webcast and Teleconference—Tellabs will host a teleconference at 7:30 a.m. Central time on Friday, April 6, 2001, to discuss first-quarter revised revenue expectations. The teleconference number is 212-231-6049. Internet users can hear a simultaneous live webcast of the teleconference at www.tellabs.com. A taped replay of the call will be available for four days, beginning at 9 a.m. Central time, at 800-633-8284. Outside of the United States, dial 858-812-6440. When prompted, enter the Tellabs reservation number: 18517124.

In 80 countries around the globe, Tellabs helps the world's leading communications service providers build tomorrow's converged networks of voice, data and video. Tellabs em-

ployees design, build and service optical networking, broadband access and next-generation switching equipment. Today most telephone calls and Internet sessions in the United States flow through equipment from Tellabs (NASDAQ: TLAB; www.tellabs.com).

Forward-Looking Statements—This news release contains forward-looking statements that involve risks and uncertainties. Actual results may differ from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, risks associated with introducing new products, entering new markets, availability of resources, competitive response, and economic changes impacting the telecommunications industry. The company undertakes no obligation to revise or update these forward-looking statements to reflect events or circumstances after today or to reflect the occurrence of unanticipated events. For a more detailed description of the risk factors, please refer to the company's SEC filings.

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Tellabs Operations Inc.
Revised Guidance Teleconference Call
April 6, 2001

Operator: Ladies and gentlemen, thank you for standing by and welcome to the Revised Guidance Conference Call. During the presentation all participants will be in a listen only mode. Afterwards you will be invited to participate in the question and answer session. At that time, if you have a question you will need to press the "1" followed by the "4" on your touchtone telephone. As a reminder, this conference is being recorded, Friday, April 6, 2001. I would now like to turn the conference over to Mr. John Springer, Director of Investor Relations for Tellabs. Please go ahead, sir.

John Springer: Thanks, Michelle and good morning everyone. With me today is Tellabs' President and CEO, Dick Notebaert and Joan Ryan, Executive Vice President and CFO. If you haven't seen the news release we issued this morning, it is available at our website, www.tellabs.com.

Before we begin, and in keeping with the safe harbor provision of the Private Securities Litigation Reform. Act of 1995, I would like to state that except for historical information, the following teleconference is based on preliminary financial results, which are subject to further review and adjustment and contains forward-looking statements that involve risks and uncertainties. Actual results may differ from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, risks associated with introducing new products, entering new markets, availability of resources, competitive response, and economic changes impacting the telecommunications industry.

The Company undertakes no obligation to revise or update these forward-looking statements to reflect events or circumstances after today or to reflect the occurrence of unan-

ticipated events. For a more detailed description of the risk factors, please refer to the Company's SEC filings. Now with that, I will turn the call over to Tellabs' President and CEO, Dick Notebaert.

Dick Notebaert: Thanks, John. Good morning everybody. By this time you have had a chance to see the news release. Joan will talk about the numbers in more detail shortly. What I want to do this morning is to use this time to give you some flavor for what we are hearing from our customers and how the current carrier-spending environment is affecting our business.

Last month we talked and we highlighted the issues we were seeing in the cable access market. There we saw our MSO customers shifting their focus from expanding their addressable market by building new infrastructure to increase profitability by signing up more customers in the places where they have the infrastructure in place. That trend continued during the whole quarter right down to the end. In just the last few weeks, however, we experienced a more controlled order flow from our larger customers than we had originally anticipated.

Clearly, the environment has resulted in near term caution in the pace at which customers are deploying equipment. Our customers are exercising a high degree of prudence over every dollar spent. Let me balance this a bit and say that everything we hear from the customers indicates that our end user demand for services continues to grow. Fortunately for Tellabs our TITAN family of products helps our carrier customers meet this demand in a cost effective way, which is the major reason we are still able to grow total revenue 20% year-over-year even in this environment. While the US market has been challenging we continue to see pockets of strength globally, particularly in Latin America.

In fact, our managed digital products which address the needs of customers outside the United States will finish virtually on plan for the quarter. From a bottom line perspective, as you would expect we are focused on doing the things we need to do in order to recalibrate our cost structure. We started this process last month when we saw the first signs of weakness and are stepping up our efforts to ensure the most profitable path through the current carrier-spending environment. Let me stop now and let me turn the call over to Joan who will give us a more detailed look at the first quarter.

Joan Ryan: Thank you, Dick. Good morning everyone. For purposes of today's call we will go through the details of the quarter only at a high level. We will be in a better position to talk about all the details of the first quarter including the balance sheet as well as guidance for both the second quarter and the full year 2001 when we formally announce our first quarter results on April 18th.

Now for the first quarter results. As we indicated in the press release issued this morning, we see first quarter revenue of approximately $772 million, which represents a 21% year-over-year growth in overall revenue. Fully diluted earnings per share of $.29, which represents 12% year-over-year growth from a major product line perspective. We see revenues of $482 million in optical networking, which represents 22% year-over-year growth. $153 million in broadband access revenues, a level that is consistent with last year's first quarter, and $33 million in next-generation switching revenues vs. $54 million in the first quarter of 2000. $104 million in professional services revenues up from $40 million in first quarter of last year. Gross margin for the first quarter was 53% and operating margin came in at 21% of revenue.

As Dick indicated, we are well positioned to manage through these challenging times showing 21% top line growth in this kind of environment is a real sign of the value Tellabs' brings to its customers. As you would expect, and as Dick talked

about, we have already begun to proactively address cost control across the entire organization. We have cut discretionary spending while we continue to ensure that we prudently invest in the future. We are aggressively managing headcount additions.

The actions we are taking will allow us to minimize the impact of slower revenue growth on the bottom line now and ensure strong profitability in the future. With that, let me turn the call back over to Dick.

Dick Notebaert: Okay Michelle, why don't we take questions now? We will take questions for about 15 or 20 minutes, folks.

Operator: Thank you. Ladies and gentlemen, we will now begin the question and answer session. if you have a question, please press the "1" followed by the "4". You will hear a three tone prompt acknowledging your request. If your question has been answered and you would like to be removed from queue, press "1" followed by "3" on your touchtone phone. If you are using a speakerphone, please pick up the handset before pressing the numbers. One moment please for the first question.

Greg Messnia/Robinson Humphrey: Thank you, Dick. Can you address the way the quarter has unfolded? It appears that the issues with TITAN 5500 surfaced late in the quarter. If you can give us a little color on that? Also, talk about the new product ramp up for the 6500 and how that is progressing against the more difficult industry backdrop? Thanks.

Dick Notebaert: Thanks, Greg. It did unfold in the last couple of weeks in the quarter. We had, if you go through and then this is a surface analysis of what happened, we had about $83 million in TITAN 5500 business that we had firm orders or LOI's and I can break that down and it would be about $36 million of firm order and the other were LOI's or indications to ship. In the last two and a half weeks or so of the quarter,

the last two week's [sic] of the quarter, what happened was customers called and said look we don't want to cancel the order and we want the equipment but could you put it into the next quarter? So we got pushed out into the next quarter, which I would tell you was surprising because you don't usually get the firm order. We don't normally have that much pushed forward especially on TITAN 5500, The good news there is that the orders weren't cancelled. It was just do it after the end of the quarter.

On the 6500, the 6500 is showing strength. In fact, you know I have said before I think on the last call when we did the revision, we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong. I don't know what else I can say about that other than it is a very bright spot for us. It looks good.

Nikos Theodosopoulos/UBS Warburg: This is Ruben Roy for Nikos. To touch on the 6500 again for a minute, can you tell me about the longer than expected testing period you had and some revenue recognition pushed over to the second quarter, are we still on track to recognize that revenue in the second quarter?

Dick Notebaert: The answer is yes and we will have more information on the revenue status when we do the first quarter earnings on the 18th. The answer is yes. Just one comment on this. We don't have a testing problem per se. It really comes back to accounting standards that say if we push a product out regardless of what the contract says the thing has to be soaked and run for a while and being an accountant I had never heard of it but Joan is keeping us straight on this.

James Parmelee/CS First Boston: On the 5500, you mentioned about $83 million in orders or order equivalents that were pushed out. Chassis vs. new customer builds vs. existing customers; can you give us a sense of those orders? Was it all

just kind of upgrades that were pushed out? How do you gauge inventory within the channel, if you will, access to cards that will be deployed as usage continues to increase at some of your customers? Do they give a sense of visibility over the next quarter or two?

Dick Notebaert: We are going to hold that question until the 18th because I don't have a breakdown of analysis yet that can give me the difference between chassis and line cards. We are still at too high a level. If you will re-ask the question on the 18th that will be fine. I would tell you that most of the business as far as the types of customers they were the larger carriers and so if I had to guess I would have to think it would be a pretty fair mix. We had some amount of the Future package and upgrade to the larger 5500 that were pushed out that we would have shipped at the end of the quarter but those were held off. I would have to estimate the number and I am not going to do that. It would have been a meaningful percentage of that and not majority or anything. It would have been some of it.

James Parmelee/CS First Boston: A clarification for Joan. Gross margins are 53% for the quarter?

Joan Ryan: Yes that is.

Steve Levy/Lehman Brothers: Two things here. One is back to the 6500, when do you think we might have a second 6500 customer announced? I know that you said you are basically shipping everything that you can. I am assuming it is not just one customer.

Dick Notebaert: That is true, Steve.

Steve Levy/Lehman Brothers: Can you comment on the timing? The second thing is on the 6100 can you give us some qualitative comments as well and timing of the first revenues on that as well?

Dick Notebaert: On the 6500, as far as the announcement goes, I wish I could have had it already. I would hope it would be as I said before I hope that it is very shortly as far as the announcement part of it goes.

Steve Levy/Lehman Brothers: Do you think the announcement is being held up for the same reasons that they might be pushing out 5500 orders?

Dick Notebaert: I don't think so. It has nothing to do with the 5500. It has to do with some "i"'s and some "t"'s in the document.

Steve Levy/Lehman Brothers: On the 6100?

Dick Notebaert: We have shipped product. The systems are complete. Most of the acceptance is done and we are waiting for the customer to hook some additional facilities into it so they can nod their head and say it is done. As far as I am concerned we could recognize it now because we have done everything we can do from an accounting point of view and the customer has to nod their head and until they put that other part of the ring in or of their network in we have to have them say it. So everything there is done.

Steve Levy/Lehman Brothers: Joan, it sounds like you are not ready to talk about guidance for the next coming quarters. Do you think this latest little surprise here is going to impact second quarter guidance?

Joan Ryan: We are currently evaluating that. We just closed the books last night and what we are giving today are flash results but we will be discussing that and full year guidance when we talk on the 18th.

Tom Dole/Lazard: Thank you. Can you give us an idea of whether there is any gross margin pressure on the 5500?

Dick Notebaert: We have had no pricing pressure other than what I am told we have as a normal portion events. Joan, do you want to add anything there?

Joan Ryan: I would say the strength of our margin, I mean I think it is product mix related and lower CABLESPAN certainly is a factor although we had higher customer service which is obviously at lower margin. We do see strength and stability of our core product margin including the 5500.

Dick Notebaert: There is the normal pressure that you get every time you sell one of these.

Michael Chin/Merrill Lynch: Sorry I got on a little bit late. Joan, did you comment at all on customer mix or geography in the quarter?

Joan Ryan: We didn't and we will talk about that when we get together on the 18th and have more details at that point in time.

Michael Chin/Merrill Lynch: At the very least, maybe Dick in this $83 million in firm orders that got pushed out, can we assume this is primarily almost exclusively RBOC related?

Dick Notebaert: No. You can't assume that. I would say a good chunk of it but some of it comes from, I don't use the expression RBOC, there are about seven large service providers. It is better to describe it that way I think rather than to just think RBOC. If you look across the board a good chunk of this is there but there is also some from the wireless. There is some from smaller IXC's. Let me just take a look here. If I took the top seven guys that would be a good chunk of it, yes.

Michael Chin/Merrill Lynch: Is there any signs of any cannibalization of 5500 sales from 6500?

Dick Notebaert: No there is not. In fact, the only thing I have heard along that line was one of you, an analyst, at one of the meetings talked to one of our customers and one of our customers made an aside about something and when we called them and asked about it he said he didn't see it that way for a while. We aren't seeing any of that and really aren't getting any of that discussion out of the customers. What we are

getting is more one of pushing the 5500 further out because of granularity. So we are not getting that kind of feedback.

Eric Buck/Dressner: Thank you. I was wondering if you had any kind of snapshot in terms of some of the balance sheet items and what you see happening on the inventory receivables and cash for the quarter?

Joan Ryan: I said that flash results would be that we see no material change from fourth quarter in terms of DSO or inventory levels. In fact, we actually see slight improvement in both of those. I will talk about it on the 18th in terms of more details if you want to analyze it and make sure our books are completely closed.

Eric Buck/Dressner: So that would imply the cash going up?

Joan Ryan: Cash was strong.

George Notter/Alex Brown: Thanks very much guys. On the 5500 for new system shipments, my guess is they have been running around 3-6 months. Can you tell us what the order rates right now look like for those systems for the 5500 that you have to go out and ship late June and into the September quarter? Is that backlog or order book really changing or are we just talking about push outs this quarter?

Dick Notebaert: What we are talking about is basically push outs this quarter. As far as our overall load that we have in front of us, order load, we are in pretty good shape there but you have to break it down between 6500 and 5500, and we can't really answer your mix question at this point. If you looked at the total amount in the system it would look very strong to you. Again, I think we have to break that down and we aren't in a position to do that today.

George Notter/Alex Brown: The sales funnel you had been looking at a month or two ago is fairly consistent with the sales funnel you are looking at now again other than the push outs?

Dick Notebaert: I would tell you that I for one and I think all of us in the Company are extremely cautious. We felt very good about what we did back in early March and to be on this call and see the push outs we are going to be very cautious. Let me just say that the sales team would like to have higher numbers and they always do but it would be a slight difference. I think it is more caution.

Operator: Ladies and gentlemen, if there are further questions, please press "1" followed by "4" at this time.

Dick Notebaert: Operator, this might be a good time for us to close the Q&A out. Let me thank everyone. We really appreciate you being with us this morning especially on such very short notice. As I said earlier, we think we have the right recipe. We think it is the recipe for success and we are very confident or as confident as ever in Tellabs' future.

We look forward to speaking with you again. I hope all of you will join us for our First Quarter Results Call when we can get into even more detail for you on April 18th. Thanks everybody. Thanks for being on the call.

Operator: Ladies and gentlemen that does conclude your conference call for today. You may all disconnect. Thank you for participating.

News Release

FOR IMMEDIATE RELEASE
April 18, 2001

Tellabs reports first-quarter earnings results

Company announces plan to align expenses with revenue and exit SALIX® product line

Lisle, Ill.—Tellabs today announced first-quarter sales of $772 million, up 21% from $639 million a year ago, driven by demand for Tellabs' core optical networking products. First-quarter net income amounted to $123 million, up 13%, from $108 million a year ago and diluted earnings per share were 29 cents, up 12% from last year (all comparisons to prior year in this release refer to the attached pro forma results of operations).

In light of reduced and deferred spending by major communications carriers, Tellabs will realign its cost structure with its current expectations for lower revenue growth. The company will further reduce discretionary spending, eliminate salary increases this year, institute a pay-cut for all corporate officers, align manufacturing capability with demand expectations, and terminate the SALIX next-generation-switching product effort.

As a result, the company will take a restructuring and other one-time charges in the second quarter for costs associated with reducing its workforce by about 550 people, consolidation of excess facilities, related fixed asset disposals, asset impairment and excess inventory. Tellabs also eliminated 450 temporary or contract positions during the quarter and will not fill 1,100 open positions. Total charges are expected to be in the range of $150 million to $225 million. On an annualized basis, the workforce-related actions are expected to reduce Tellabs' overall cost structure by approximately 5% to 6%.

Tellabs now expects 2001 revenues of $3.6 billion to $3.7 billion; 2001 earnings per share are now expected to range between $1.55 and $1.65, excluding the goodwill from the acquisition of Future Networks Inc.

"These actions are unfortunate because they affect a lot of talented people," said Tellabs President and CEO Richard C. Notebaert. "By paring back our efforts in next-generation switching, we are aligning with our customers' priorities and strengthening our initiatives in high-growth areas such as optical networking. Despite the current challenges, I am as confident as ever in Tellabs' long-term prospects and our ability to deliver strong revenue and earnings growth in the future."

Optical Networking—For the first quarter 2001, sales of optical networking equipment rose 22% to $482 million. During the quarter, Tellabs shipped 3 million DS-1-equivalent ports of TITAN 5000 series optical networking products and continued to ship its new TITAN® 6000 series products for customer deployment.

Broadband Access—Sales of broadband access products amounted to $153 million, which was consistent with last year's quarter. Sales of the managed digital network product line posted year-over-year improvement, which offset slower sales from the CABLESPAN® product line. During the quarter, Tellabs completed its acquisition of Future Networks Inc., a leader in standards-based voice and data modem technology, which enables Tellabs to provide cable operators with a complete solution for cable-data modem and voice-over-IP services.

Voice-Quality Enhancement—Sales in the voice-quality-enhancement market amounted to $33 million, compared with $54 million last year. During the quarter, Tellabs announced voice-quality enhancement contracts with major carriers such as Globtel and KPN International Network Services.

Services and Solutions—Building on growth in its core optical networking business, Services and Solutions revenues increased 160%, to $104 million in the first quarter of 2001.

Simultaneous Webcast and Teleconference Replay—Tellabs will host a teleconference at 7:30 a.m. Central Time on Wednesday, April 18, to discuss first-quarter 2001 results. Internet users can hear a simultaneous live webcast of the teleconference at www.tellabs.com. A taped replay of the call will be available for 48 hours, beginning at 9:30 a.m. Central Time, at 800-633-8284. (Outside the United States, call 858-812-6440.) When prompted, enter the Tellabs reservation number: 18414716.

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For a more detailed description of the risk factors, please refer to the company's SEC filings.

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TELLABS, INC.
Results of Operations
(Dollars in thousands, except per-share data)

	Three Months Ended	
	03/30/01	03/31/00
Net Sales	$772,108	$631,285
Cost of Goods Sold	366,202	299,094
Gross Profit	405,906	332,191
Operating Exp.		
Mktg. & G.A.	111,060	86,966
Research & Dev.	127,604	93,020
Merger Costs	---	5,760
Goodwill Amort.	4,505	3,015
Total Oper. Expenses	243,169	188,761
Oper. Profit	162,737	143,430
Interest/ Other-Net	16,105	37,771
Profit Before Tax	178,842	181,201
Income Taxes	56,335	60,690
Net Profit Before Cum. Effect	$122,507	$120,511
Net of Tax	---	(29,161)
Profit After Cum. Effect	$122,507	$91,350
Earnings per Share Before Cum. Effect:		
Basic	$0.30	$0.29
Diluted	$0.29	$0.29
Cum. Effect per Share:		
Basic	---	$0.07
Diluted	---	$0.07
Earnings per Share:		
Basic	$0.30	$0.22
Diluted	$0.29	$0.22
Average Number of Shares of Common Stock Outstanding		
Basic	408,771	408,794
Diluted	416,282	418,909

TELLABS, INC.
Proforma Results of Operations
(Amounts in thousands, except per-share data)
(Unaudited)

	Three Months Ended	
	03/30/01	03/31/00*
Net Sales	$772,108	$639,490
Cost of Goods Sold	366,202	307,916
Gross Profit	405,906	331,574
Operating Exp.[1]		
Mktg. & G.A.	111,060	86,966
Research & Dev.	127,604	93,020
Goodwill Amort.	4,505	3,015
Total Oper. Expenses	243,169	183,001
Oper. Profit	162,737	148,573
Interest/ Other-Net[2]	16,105	14,022
Profit Before Tax	178,842	162,595
Income Taxes	56,335	54,469
Net Profit	$122,507	$108,126
Earnings per Share		
Basic	$0.30	$0.26
Diluted	$0.29	$0.26
Average Number of Shares of Common Stock Outstanding		
Basic	408,771	408,794
Diluted	416,282	418,909

Pro-forma Adjustments

* Year 2000 results of operations are not restated to reflect the adoption of the Securities Exchange Commission's Staff Accounting Bulletin No. 101.
(1) 2000 results exclude a pre-tax charge of $5.8 million ($0.01 per diluted share) related to the merger with SALIX Technologies, Inc.
(2) 2000 results exclude a pre-tax gain of $19.2 million ($0.03 per diluted share) on the sale of stock held as an investment and a pre-tax gain of $4.6 million ($0.01 per diluted share) on a distribution from one of the Company's technology investments.

TELLABS, INC.
Condensed Consolidated Balance Sheets
(Dollars in thousands)

	2001 First Quarter	2000 Year End
Assets		
Current Assets		
Cash and investments	$1,019,064	$1,022,347
Accounts receivable, less allowance	594,936	802,546
Inventories	533,941	428,25
Other current assets	54,965	69,331
Total Current Assets	2,202,906	2,322,479
Property, Plant and Equipment	814,525	756,895
Accumulated depreciation	(311,510)	(296,134)
	503,015	460,761
Goodwill	167,303	73,924
Other Assets	213,176	215,903
Total Assets	$3,086,400	$3,073,067
Liabilities		
Current Liabilities		
Accounts payable	$136,503	$155,006
Accrued liabilities	119,953	164,045
Income taxes	46,769	93,294
Total Current Liabilities	303,225	412,345
Long-Term Debt	2,850	2,850
Other Long-Term Liabilities	26,938	24,221
Deferred Income Taxes	925	6,067
Total Liabilities	333,938	445,483
Stockholders' Equity		
Common Stock, $.01 Per Value	4,112	4,112
Additional Paid-In Capital	472,809	441,909
Treasury Stock	(126,476)	(126,476)
Cumulative Translation Adjustment	(154,255)	(127,018)
Unrealized Holding (Losses) Gains on Securities	(4,861)	(3,559)
Retained Earnings	2,561,123	2,438,616
Total Stockholders' Equity	2,752,462	2,627,584
Total Liab. And Stockholders' Equity	$3,086,400	$3,073,067

Tellabs Operations Inc.
First Quarter 2001 Teleconference
April 18, 2001

Operator: Ladies and gentlemen, thank you for standing by and welcome to the Tellabs Investor Relations conference call. At this time, all participants are in a listen only mode. Later, you will be invited to participate in a question and answer session. At that time, if you have a question you will need to press the "1" followed by the "4" on your telephone. As a reminder, this conference is being recorded, Wednesday, April 18, 2001. I would now like to turn the conference over to Mr. John Springer, Director of Investor Relations. Please go ahead, sir.

John Springer: Thank you, Daryl. Good morning everyone and welcome to Tellabs First Quarter 2001 teleconference. With me today is Tellabs' President and CEO, Dick Notebaert, Joan Ryan, Executive Vice President and CFO, and Brian Jackman, President of Global Systems and Technology. By now you have all had a chance to see the earnings release we issued earlier this morning. If not, the release is available at www.tellabs.com

This morning Dick will start with a look at the actions we are taking to maintain strong profitability and focus on the Company's product offerings. Joan will go through the first quarter results in detail and updated guidance for second quarter and the remainder of 2001. Then we will open the floor to questions for Dick, Joan, and Brian. Before I being [sic], I have two things to mention. First, the year-over-year comparisons we present today are based on pro forma 2000 results, which are included in the press release for your reference.

Second, in keeping with the safe harbor provision of the Private Securities Litigation Reform Act of 1995, I would like to state that except for historical information, the following teleconference is based on preliminary financial results which

are subject to further review and adjustment and contains forward-looking statements that involve risks and uncertainties. Actual results may differ from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, risks associated with introducing new products, entering new markets, availability of resources, competitive response, and economic changes impacting the telecommunications industry.

The Company undertakes no obligation to revise or update these forward-looking statements to reflect events or circumstances after today or to reflect the occurrence of unanticipated events. For a more detailed description of the risk factors, please refer to the Company's SEC filings. With that, I will turn the call over to Dick.

Dick Notebaert: Thanks, John. Good morning everyone and thanks for joining us. Tellabs had a relatively solid performance in what was clearly a challenging quarter for the entire industry. However, the quarter clearly did not live up to our expectations. Declining business trends we experienced late in the quarter indicates that we are operating in a different market than we were just a few short months ago. In fact, a very different environment than it was just a few weeks ago. Our customers are reviewing, and in some cases, reducing their capital spending plans so we have factored that in when forecasting our business trends through 2001. To ensure we continue to maximize our profit potential through the current environment, we are recalibrating our cost structure.

In today's news release we outline some of the actions we are pursuing. Given the current environment, we are acting decisively to align our cost structure with our expectations for lower growth.

As outlined in the news release, we will further reduce discretionary spending and eliminate salary increases for Tellabs' employees this year. We will institute and have insti-

tuted a pay cut for all corporate officers. We will align our manufacturing capability with our demand expectations for this year and we will exit our current next-generation switching product effort.

Let me explain further. We have decided to terminate our SALIX next-generation switching program. This was, of course, the most difficult decision we had to make because of the direct effect it has on the lives of so many very talented Tellabs' [sic] employees.

In my recent conversations with many of you, I have tried to make the point that Tellabs actively participates in two product segments—optical networking and broadband access while characterizing our activities in next-generation switching as aspirational. I say that because we have not achieved significant traction with the SALIX platforms.

In addition, the switching market is changing rapidly. From a technology standpoint, we are still in a transition. A transition that is likely to ultimately lead us to solutions that are fundamentally different from what can be delivered by today's technology. We simply are not convinced that the current model will generate sufficient returns that warrant continued investments. We are changing our approach. From this point, Tellabs will no longer pursue any sales activities related to any of the products in the SALIX program. Let me make it clear, we will continue to pursue this market opportunity and will be leveraging everything we have learned over the last few years by focusing our development efforts on a new set of solutions.

This decision will enable us to accelerate our initiatives into other high growth and high return areas which are our core competencies. To this end, we are reassigning a portion of the engineers towards developing feature richness in optical networking. By doing so, we will help drive further improvements in time to market, which is one of our key objectives.

We will also resize and restructure our manufacturing capacity in New York for optical production to help satisfy the strong demand that we are seeing. The net result will be a reduction in headcount of approximately 550 employees or approximately 6% of our total workforce.

In addition, we have eliminated about 450 contract and temporary employees. We will not fill 1100 open requisitions that we currently have. In addition, in Illinois and in Texas, our manufacturing will adopt a four day work week from April 23rd thru June 1st, that is, except for our TITAN 6500 product lines, which we will continue to run full board.

The employee costs associated with these actions as well as the charges associated with consolidation of excess facilities, related fixed asset disposals, asset impairment, and excess inventories, will be recognized through restructuring and other one-time charges during the second quarter.

In total, we anticipate the charges to be in the range of $150-225 million. On an annualized basis, these actions are expected to reduce Tellabs' overall cost structure in the approximate range of 5-6%. Initial savings are expected to begin in mid-second quarter with full range reduction expected in the third quarter. The specific components contained within the restructuring and the one-time charges will be quantified and reported in the May timeframe once we complete our full analysis.

Doing the right thing for the long-term health of the business, however painful, is in the best interest of all our shareowners. In a moment Joan will discuss our revised guidance for the second quarter and the balance of 2001.

Essential to the viability of that guidance are the actions we have undertaken today. For this reason, we did not update guidance until we were able to finalize these actions. Moving forward, Tellabs has a strong franchise based on the right strategies, the right products, the right customers, and great

employees. Despite the current challenges our core business is solid and the customer input we are getting on the TITAN 6000 series tells us that our future revenue path is intact. With the actions we announced today, we will help ensure that we continue to drive strong profitability. With that, let me turn the call over to Joan. Joan?

Joan Ryan: Thank you, Dick. I will start this morning with the details of our first quarter results. Net income for the first quarter increased 13% to $123 million. That compares to $108 million in the first quarter of 2000 excluding one-time items. Diluted earnings per share were $.29 including goodwill of approximately $.01 per share associated with the February Future Networks acquisition. This represents a 12% increase over the $.26 recorded in the first quarter of 2000 excluding the one-time items.

We will start with the income statement beginning with revenue in terms of the details. Optical networking revenue at $482 million for the quarter was 22% above last year's first quarter. We shipped over 3 million DS1 equivalent ports in the first quarter for the TITAN 5000 series and that is up 29% vs. last year. Broadband access revenues of $153 million were consistent with last year's level. Sales of our managed digital network product line posted a year-over-year improvement in the first quarter, which offset slower sales from our CABLESPAN product line. Voice quality enhancement revenues were $33 million in the first quarter and customer services and solutions revenue were $104 million, which represents another strong quarter for that sector.

Turning now to the profitability aspect of our business. Operating income rose 10% for the quarter and despite lower than expected revenue growth in the quarter, we delivered a respectable operating margin of 21%. Gross margin for the first quarter was 53% or about two points lower sequentially due to product mix related changes. As expected, core prod-

uct gross margins remained consistent with fourth quarter levels.

Turning to operating expenses. R&D expenses rose to $128 million, which represents 16.5% of sales. Sales general and administrative expenses were $111 million or 14% of sales. In total, operating expenses as a percentage of sales were above trend at 31% as our expense budget was calibrated to a 35-40% revenue growth rate for the quarter. Expense control is a major focus area for us as we continue through 2001. Dick highlighted the measures we are taking to bring down our cost structure.

Other income excluding one-time items increased $2 million vs. last year primarily as a result of higher investment income from our cash and investment balances. As expected the tax rate for the quarter came in at 31.5%.

Turning now to the balance sheet. Accounts receivable decreased 26% sequentially to $595 million from $803 million last quarter. Day sales outstanding at 70 days was improved vs. the 72 days achieved for the fourth quarter.

Inventory turns at three times were down from the 4.7 times at the end of the fourth quarter. Inventory in terms of dollars increased by $106 million sequentially. Last week we gave indications that inventory levels would be down and that was based on very preliminary results. The books are now completely closed having fully analyzed numbers and the sequential increase we experienced was primarily driven by continued shipments of our new TITAN 6000 series products in the quarter, which were not recognized as revenue this quarter, inventory build related to optical networking orders that were deferred late in the quarter, as well as a build up of CABLESPAN inventory due to the slower sales growth in the quarter vs. our original forecast.

We are currently evaluating the impact of the termination of the SALIX next-generation switching program as well as the

recent slowdown in customer demand may have on the carrying value of our finished goods component inventories. An estimated charge for excess inventory is included in the range of the restructuring and one-time charges that Dick talked about earlier.

Operating cash flow for the first quarter was approximately $145 million, which is up sequentially from the fourth quarter. Cash and investments totaled just over a billion essentially flat with fourth quarter levels. The primary non-operating use of cash in the quarter came from our acquisition of Future Networks, which closed in February. Actual number of shares outstanding were approximately 409 million at the end of the quarter.

Now let's address our outlook. Let me start by putting some quantitative details around the initiatives Dick mentioned earlier. As you know, we will be taking a restructuring charge plus one-time charges in the second quarter. The guidance I will provide today which follows will exclude these charges but include the related costs and expense savings. The actions we are taking to align our cost structure with lower revenue growth will allow us to hold expected operating expenses for the second quarter through the fourth quarter in the range of $240 million consistent with the first quarter. In total, this results in a 9% savings vs. our plan for the full year, our budget for the full year.

Now to the revenue for the year. We are now forecasting year revenue to be in the range of $3.6 million to $3.7 million. Our updated revenue estimates are based on the following expectations by product groups. For optical networking products we expect 10-15% year-over-year growth with the TITAN 6000 series products contributing approximately $175 million in revenue.

Broadband access revenues are expected to be flat and slightly down vs. the year 2000. We are forecasting a 10-15% decline in voice quality enhancement revenues and a 50% growth in special services.

Based on the expected mix of revenues, gross margin for the full year 2001 is expected to be in the low 50% range. We expect operating expenses as a percent of total revenues to be in the mid 20% range and that would be driven by sequential improvements in operating expense rate through the remaining three quarters of the year. Based on these forecasts, we expect to deliver a solid operating margin in the mid 20% range for the full year 2001.

From an earnings perspective, we now expect full year earnings per share to be in the range of $1.65 per share and that would exclude the related dilution of $.04 per share relating to our acquisition of Future Networks. With respect to the second quarter, we are targeting total revenue of approximately $780-820 million, which is slightly higher sequentially. We are estimating optical networking and voice quality enhancement revenues slightly higher sequentially. Broadband access and Customer service revenues are expected to be slightly lower sequentially.

Gross margins will be sequentially lower in the second quarter due to a higher mix of professional services revenue as well as the new product start-up costs and manufacturing scale impacts associated with those new products. Operating expenses are flat sequentially for the second quarter as we begin to see by mid quarter the effects of the expense reduction initiatives that Dick highlighted earlier.

As a net result, operating margins are expected to be flat. All of this leads us to target second quarter earnings per share in the range of $.29 to $.32 excluding one cent of goodwill from the Future Network acquisition. Now I will turn the call over to Dick for some closing comments.

Dick Notebaert: In summary, I think we are heeding the warnings we got in the last few weeks, late in the first quarter, and we are responding by tightening our belts during the market uncertainty so we can help assure that we navigate through these times both profitably and sensibly. By sharpening our strategic focus I think we are ensuring that our internal resources are optimally aligned towards the initiatives that will drive our future, profitable growth.

At this point, I will open it for questions. We will limit the call to about an hour so please everyone be thoughtful in asking questions and limit it to one.

Operator: Ladies and gentlemen, if you have a question, please press the "1" followed by the "4". You will hear a three tone prompt acknowledging your request. If your question has been answered and you would like to be removed from queue, press "1" followed by "3" on your touchtone phone. If you are using a speakerphone, please pick up the handset before pressing the numbers. One moment please for the first question.

John Butler/SG Cowen: Question on visibility. At the end of March you indicated that orders had fallen off quite dramatically and quite suddenly and I was wondering if you could speak to how those trends carried over into the current quarter. If you can sort of add a little color on that on what you are hearing from your customers.

Dick Notebaert: The large service providers continue to view our products and services in a very bright light and we continue to have growth there, not as high a growth as we had last year. On the CLEC side and on the smaller service provider side, we see the same things that you read about in the press and we hear the same things from them. There is a lot of people having a difficult cash position and so everyone is being very judicious in how they spend it Brian, anything you would add to that?

Brian Jackman: No I think that is pretty much the trend we see. We see pockets of stronger geographic areas. Europe has not quite felt as much of a slowdown as the States have and one of the issues we have with visibility is take a look at the impact of new products. We are seeing very strong and very visible demand, for example, in the new 6500. As Joan indicated, it will just take us a little time to turn that into recognized revenue. I think we are well on our way to do that.

John Butler/SG Cowen: Can you speak to the order trends so far this year?

Brian Jackman: I am calling in from Ireland right now and I don't have the data in front of me. Maybe Dick would want to comment on that.

Dick Notebaert: Joan, why don't you pick that up?

Joan Ryan: Our book to bill in the first quarter was greater than one. If you look at our overall backlog, and I will do it first without 6500 so we have apples to apples vs. where we were a year ago, our backlog at the beginning of the second quarter is flat year-over-year. If you include TITAN 6500, the backlog is up substantially year-over-year.

Dick Notebaert: Of course, the 6500 as we have talked about in our prior calls, we don't hit full ramp until end of May or early June. We are flat out on it now but we won't be able to see the full impact of that until the fourth quarter ramping up from the third quarter.

Alex Henderson/Salomon Smith Barney: Just a technical question. The goodwill exclusion here is just the goodwill associated with the acquisition? You are still carrying amortization and goodwill deferred comp costs in the income statement in future quarters?

Joan Ryan: That is correct.

Alex Henderson/Salomon Smith Barney: We should still be using the same model of forecasts that we have been using?

Joan Ryan: Yes. I excluded it so we would have an apples to apples comparison as you look at 2000 vs. 2001. What you would do to just reduce the numbers I gave you is by four cents which relates to that goodwill.

Alex Henderson/Salomon Smith Barney: So the reported numbers then will include that goodwill because that is consistent with the way you are reporting?

Joan Ryan: That is exactly right.

Alex Henderson/Salomon Smith Barney: Can you give us some sense of what is going on with the 5300? Is that part of the area that slowed down here? Also, can you give us an update on the 6100 and 6200 products as well as Focus? Are you finding any traction to those DWDM products?

Dick Notebaert: The 5300 has slowed down compared to last year's growth. On the 6100, we are getting excellent reception for it. Brian, you want to talk about the 6200?

Brian Jackman: The 6200 tends to get buried inside the general Focus product line because it is part of that area. Actually that Focus product line in general, including the 6200, has been a very strong product line for us during this past quarter. The outlook for it for the rest of the year also remains nicely strong. We had some good news from a major global customer just in the last couple of days that is going to be deploying that at a new network. I am pretty encouraged about that space.

Alex Henderson/Salomon Smith Barney: Given comments about the elimination of SALIX, can you talk about what you are doing to incorporate soft switch type technology into the CNTS applications in the broadband access segment?

Brian Jackman: In the near term we have a couple customers who are entertaining bids and of course as you know we are working with Riverstone on an OEM basis for their CNTS. On these bids we are partnering with soft switch partners on

an application by application basis. We are talking to several people in that space and depending on what features and functionality are required by a particular bid we are partnering with people at that time. We have not selected what I might describe as a longer term strategic partner. We are working with a couple.

Alex Henderson/Salomon Smith Barney: Is the Riverstone partnership as targeted as it has been?

Brian Jackman: Riverstone partnership is still moving forward and I would say we are not quite ramping the revenue that we had hoped but a lot of this is dependent on these decisions which are pending so we are still very encouraged about the relationship.

Eric Allard/Will Banks Smith & Thomas: Good morning. Can you provide the actual sales number for CABLESPAN in the quarter? Also, tell me what that equated to in terms of growth or lack of growth in a sequential and year-over-year basis and provide any additional color in terms of the outlook in that part of the business.

Dick Notebaert: I will tell you that it is much softer and down, way down, from where we would have been last year on the ramp we were on. In addition, it is well below our plan and it was a significant part of revised guidance. We don't see that hardening up at least over the next few quarters based on conversations with specific customers. I don't think we will see a lot of change on that in the near term.

Eric Allard/Will Banks Smith & Thomas: Can you roll out or confirm is the primary issue one of industry wide problems or should we be worried about product specific issues with regard to CABLESPAN?

Dick Notebaert: There is no softness because of anything competitive going on. It is in fact across the industry. In fact, we are getting very good feedback from the presentations we

have made and even in the ones I have been involved with where we get good feedback from customers in Europe and in the United States. We have had encouraging news in Europe as far as opportunities in countries we were not operating in. We find ourselves in a strong position. It is an industry problem in cable.

Andrew Chopik/Nutmeg Securities: Thank you very much. The relationship with Calient, can you discuss that at all which may be having some difficulty with funding or whatever? How is that effort progressing?

Brian Jackman: That investment is an interesting investment in a good company with some good technology. It is really a venture investment from our part but we think it is strategically aligned with our interest of moving forward to more intelligent optical switching alternatives. We like what we see there. We have been talking recently about funding status and so forth but I think the comment you made is sort of generic to that space. So we will be watching that carefully. They have not come to us for example and said that they have financial problems near term and, in fact, recently I think just the opposite was true.

Andrew Chopik/Nutmeg Securities: Share buyback, you announced in October, have you actually taken any action in terms of share buybacks?

Joan Ryan: We have bought back about ¾ of that announcement. We will likely execute the remainder in the following quarter.

Andrew Chopik/Nutmeg Securities: Can you be more specific in terms of what the buyback was?

Joan Ryan: I believe it was 3 million shares out of 4 million that were purchased back. I think we did a good job.

Nikos Theodosopoulos/UBS Warburg: I have two questions. Any sense of what the unit growth is in terms of new systems year-over-year on the TITAN 6500?

Dick Notebaert: We did have growth in new systems and it was down slightly from last year but still very high. I wish everything was that high. We had just over 3 million in port growth.

Nikos Theodosopoulos/UBS Warburg: The port growth was 29% and the units of new systems was flat or down?

Dick Notebaert: I did not say that. The new systems would have actually been a higher number than that.

Nikos Theodosopoulos/UBS Warburg: On the 6000 series you gave guidance of $175 million for the year which is a big ramp. What kind of update on number of customers or something to give us confidence that that number is achievable and maybe some rough number of what it can be in Q2?

Dick Notebaert: What will happen in Q2 is we will be recognizing the revenue of the systems we shipped late in the fourth quarter and the ones in the early first quarter. The numbers that Joan gave you as far as backlog goes have this included in it. As far as customer numbers, I don't think we will speak to that.

Joan Ryan: I would say what Dick just said is correct. The backlog is flat year-over-year excluding 6500 but up substantially if you include it. That speaks to some of the visibility we see and it will ramp. We will see revenue recognition in the second quarter and it will continue to accelerate as we move forward through the year. The manufacturing capacity piece of it is one of the drivers because we will be then at full capacity toward that forecast in the May/June timeframe.

Dick Notebaert: The gating factor is our manufacturing capacity.

Nikos Theodosopoulos/UBS Warburg: Do you have deployment orders from more than that customer at this point?

Dick Notebaert: We have orders from more than that customer. We have orders.

Greg Mesniaeff/Robinson Humphrey: Thank you. Can you give us a breakdown of frames to port cards on a percentage basis? What was it this quarter vs. a year ago and in the fourth quarter?

Joan Ryan: In terms of sequential growth we had a mix of higher port cards as a percentage of sales sequentially. We continue to have solid demand for new systems. If you look at the next seven consecutive quarters we have had very strong system sales and the benchmark we set for ourselves, in terms of a target, we have achieved that internal target in the last seven consecutive quarters. I think that speaks to the overall health of our business and the annuity potential of the 5500.

Greg Mesniaeff/Robinson Humphrey: Can you give us detail on 3000 port frames, is that shipped at any meaningful volume in the first quarter?

Joan Ryan: It did. We shipped several systems and we had more backlog into the second quarter.

Brian Jackman: On the new systems vs. growth numbers if you look back at the year ago comparable quarter and the last couple of quarters the numbers really have not on a percentage basis moved more than a couple percentage points. In the past we were using the new systems and system expansions as sort of a 40% number and the growth around a 60% number and we are still very much in that range as far as the revenue breakdown.

Jeff Lipton/J.P. Morgan: Can you give us a little color on $175 million, a ballpark of 6500 vs. 6100?

Brian Jackman: I would say now the plan is that the bulk of that is going to be the 6500. I don't think we want to give

specific numbers out. I think there is a predominant number there and probably 80% or so is going to be made up of 6500 frames. Quite frankly we have either firm orders or letters of intent for a number much larger than that. To the prior question about ramp, it is a manufacturing ramp issue but is not quite as bad as it appears because we sort of have this revenue recognition ramp folded on top of it, which hides the fact that we are shipping and physically installing a large number of frames as we speak.

Jeff Lipton/J.P. Morgan: For the 5500, any change in pricing or competition from some of the newer entrants?

Dick Notebaert: No. The pricing pressure we get is a pricing pressure we get every year that the sales force gets about buying a lot of our products and you need to give us a better discount. We are getting the normal pressure but not from competitors dropping prices.

Joan Ryan: Our margin for our core products has remained stable. It is forecasted to do that as well within the full year guidance I provided.

Ken Leon/ABN Amro: In the guidance for the full year, is that affirming that more service providers are deferring and will spend aggressively in the second half or what will drive "V" shaped earnings leverage you have given the flat second quarter? The next quarters are going to be very difficult comparisons on the TITAN 5500 sales of last year so will year-to-year growth comparisons be negative or do you still expect slight positive growth?

Dick Notebaert: We have said all along that a great deal of the ramp relates to the 6500 and the opportunity we have with the 6500 and our ability to produce and install and recognize revenue on that product based on what Brian said about LOI's and orders. That is extremely important to us and is in fact a large part of what you are talking about.

Joan Ryan: The guidance we gave was a slight growth in that in the second quarter and as we move through the rest of the year. As Dick said, the 6500 ramp.

Ken Leon/ABN Amro: Large service providers are not cutting back on their capital spending this second half? They are just deferring?

Dick Notebaert: I don't know that I would say they are deferring in the second half. We had this experience going on that the input we get with largest customers are that their overall cap X is flat and slightly down. They see a need for continued grooming and efficiency and we are in a sweet spot. However, that says we aren't going to get the level of growth say on the 5500 that we experienced last year in the 40+ range. We still will have solid business here. On the 6500, we are not getting an indication of deferral. If anything, we are catching a little grief about the fact that they would like us to ramp up faster.

Eric Buck/Dresner Klineworth & Wasserstein: Thank you. Can you address the inventory mix in terms of finished goods and components? How much of that is actually product in the field and could be recognized revenue in the future? Secondly, SALIX termination and a new set of solutions that are coming along, can you address what you are seeing there or how that plays out in terms of your own product lines?

Joan Ryan: The inventory piece relative to the mix of raw materials, work in process, finished goods, raw materials were up in the first quarter vs. a year ago as well as finished goods being up. Those are really driven by the increase relative to softness in CABLESPAN that was unforecasted as well as preparing for ensuring we have the right products on hand as we move forward with our new product ramp for the TITAN 6000 series.

Eric Buck/Dresner Klineworth & Wasserstein: Do you have the actual numbers for those?

Joan Ryan: Absolutely. Raw materials would be $250 million. Work in progress is $62 million and then finished goods of $221 million.

Eric Buck/Dresner Klineworth & Wasserstein: Of that 221, how much is actual product in the field?

Joan Ryan: We would not disclose that. The point is we have shipped in the fourth quarter and in the first quarter and even into the second quarter the 6100, 6500, which will be basically what materializes into revenue into the second quarter.

Dick Notebaert: We in the process of constructing our TITAN 6700 prototypes and that has created within this an expense and so that is a sizeable number we have to deal with. The other part of your question, which was on SALIX and next-gen, and Brian and I have discussed this a lot but I don't know how much we want to talk about it at this point.

Brian Jackman: If it wasn't anybody other than Eric, I would say let's say nothing. Eric, I think we would like to say almost nothing because we don't want to tip our hand at what we are doing yet especially since we know next quarter you guys will call us back and say you are late with the program. Let me say that we feel that the level of investment necessary to maintain a standalone media gateway program in conjunction with soft switch and so forth is a very expensive undertaking with a relatively short market life before we think that functionality will get integrated into other related and perhaps higher order systems.

Dick Notebaert: We tested the concept of what Brian is talking about with several of our customers and have gotten pretty good feedback from those customers. Those have been large service providers as well as what you would call newer service providers that are on the leading edge.

Paul Silverstein/Robertson Stevens: You said that the 5500 increased in new systems and was slightly down from last year. I am confused.

Dick Notebaert: I didn't say that. Let me clarify. If I look at the total number and take first quarter '01 vs. first quarter of '00 it is down slightly in total new systems shipped.

Brian Jackman: If I can add something there. What we did see was in the absolute number of brand new systems a slight decrease against the comparable quarter. We are also seeing another kind of mix because of the fact that we now have these 2000 port and 3000 port systems available. We are seeing a very, very large increase on a comparable basis in a number of what we refer to as core expansions, which is almost like selling a new system. When someone says they want to go from 1000 ports to 3000 ports you bring in all the main components to do that. We have seen a very significant increase in that and so that has been more than an offset to slight system decrease.

Paul Silverstein/Robertson Stevens: Is there a difference in terms of gross margins?

Brian Jackman: No it is negligible.

Paul Silverstein/Robertson Stevens: Can you give us insight in terms of the 6100 and numbers of customers?

Brian Jackman: We have one customer whose system is up and running and deployed. We expect to have revenue this quarter and we have several trials and a couple of major opportunities underway right now as we speak.

Paul Silverstein/Robertson Stevens: Can you update us in terms of what you are seeing in the 83 million deferred orders?

Dick Notebaert: Not yet. It is too early in the quarter. It has only been two weeks since I talked to you before and there has not been a change in the status at this point.

Joan Ryan: We factored that into the guidance in terms of the backlogs we have along with some of the behavior change we saw late in the fourth quarter. That is what you are seeing

reflected in the second quarter as well as the remainder of the year.

Paul Silverstein/Robertson Stevens: Have you all come up against quarter [inaudible]

Dick Notebaert: We have seen customers buying it. As far as going head to head, we have not gone head to head with it.

Michael Ching/Merrill Lynch: Thanks. Last year you sold about 14 million DS1 equivalent ports for the TITAN 5500 and what is the assumption in terms of total number of ports you will sell this year? Can you comment on Martis and Focus gross margins relative to the corporate average and give us some sense of where the 6500 gross margins will be relative to the corporate average once it starts to ramp?

Joan Ryan: The Martis and Focus is higher than the corporate average. We continue to enjoy that benefit relative to our overall gross margin. In terms of the 6500, the new product start-up costs and manufacturing scale impact is having a factor relative to our overall margin which would imply that that is lower than average. We do have our engineering folks very focused on cost reduction as we have done with every one of our products over the life cycle of all of our products. A continual focus on cost reduction along with the fact that as we get scale for the 6500 and work out start-up costs we would see them being more in the average range of our margin.

Brian Jackman: I don't really have a number. I guess we could extrapolate for the year but we grew the installed base of the ports just in this past quarter by almost 10%. We certainly expect sequential growth as the year goes on for the 5500. I think you could expect that number will be some place in the 4 to 5 times the first quarter experience. The other thing is still the dominant services being provided by these frames are DS1 and DS3. We shipped a very large number of DS3 and SG&S cards. While these systems are

heavily populated with optical interfaces, at the service level people are still buying copper.

Michael Ching/Merrill Lynch: You had a 29% increase in DS1 but would you expect the full year number to be up in that same range?

Brian Jackman: I think so.

Dick Notebaert: If you look at how our quarters have played out over the years and the buying pattern it is a different environment now but if you use any of the historical guidance you would look at the first quarter as being about 20% and then it starts to ramp with the fourth quarter being the biggest. That is a historical view and the environment is different. If you took the first quarter in last year's environment you would say it would be about the same. Again, it is a different environment and that is why you are hearing some hesitancy.

Truc Drew/Lazzard & Company: Regarding the change in spending behavior by the large carriers, do you get the sense that these carriers are spending less because they see less demand for their services or they are just being cautious or they are asking for a better discount?

Dick Notebaert: It varies by individual service provider. In general, on the demand side when I talk to everyone there is a consistent theme that says demand is there. Now, you know if you are talking local exchange, second lines maybe are down and there is some softness there. As far as demand across that group the demand is there. I am not talking about backbone OC192. I am talking about Tellabs' products. The demand for our products especially in the 5500 space I consistently get the statement that demand they receive is there. That is where the dichotomy comes because the cap X goes down but the demand is there and as a service provider you are by definition a service provider so how that budget whether it is flat year-over-year in aggregate terms or down 3-5% depending on the provider or maybe more in aggregate, how do you

allocate that? That is the issue going on within the large service providers. How do they allocate their cap X?

George Nodder/Deutsche Bank: Thanks very much. Are you assuming any improvements in your market share on the TITAN 5500? There are a few accounts in North America that are Alcatel accounts as opposed to Tellabs' accounts. Do you think you will pick up any share to move places?

Joan Ryan: We actually gained share last year in this space. When we put the guidance together we said sequential improvements for the TITAN 5500 series and I think it is certainly possible we would gain market share given our product vs. the competition and some of the things we feel that

Dick Notebaert: We are very strongly positioned there.

Joan Ryan: Yes.

Brian Jackman: I agree. I think we have a relatively high share now and based on both products and the fact that we continue to invest in this product and the dynamics of the market we would pick up some small amount of percentage increase.

George Nodder/Deutsche Bank: Is that already built into the expectation or it implies roughly equivalent market share?

Joan Ryan: I have given that we have less than normal visibility. The answer to that is yes.

Steve Levy/Lehman Brothers: This is Mark Schmidt for Steve Levy. In terms of the impact of the SALIX shutdown, can you give us a sense of operating expense savings that will come from the SALIX shutdown? Do you expect any asset write-downs? What kind of customer commitments did you have for the SALIX products?

Dick Notebaert: A lot of the savings comes from the closure of our next-generation switching effort and that is both across

the engineering groups, R&D, and of course there will be asset write-downs because we did have inventory built up. We did have situations where we had built and some trials going on that we will have to extricate ourselves from. Yes that is a big chunk.

Larry Harris/Josenthal: Thank you. We are seeing softer demand for the 5300? Is there something particular that is driving that like wireless applications or other applications?

Dick Notebaert: There is softer demand.

Brian Jackman: I don't have that breakdown now but I suspect it is a combination of wireless and some of the smaller CLEC's.

Dick Notebaert: I would agree with that. It is not on the larger end. One more question.

James Parmelli/Credit Suisse First Boston: On the positive side, CABLESPAN volumes have been below expectation and that gives a positive margin benefit given it is lower than corporate average margins. Are we at the low at 52.5% or do we see a little more weakness given what you described on the 6500 ramp and some of the overhead associated with that? Also, the 83 million orders currently factored into guidance, are you assuming that will ship in Q2 or is part going to ship in Q3 and Q4?

Joan Ryan: Gross margin, you are right about CABLESPAN with lower than average margin so that has a benefit. Higher customer services is a mix. We talked about very strong growth in that going forward. That somewhat offsets that. There probably is some marginal difference between where you are at vs. what we are thinking about but very marginal. Again, core product margins are estimated to remain stable.

Dick Notebaert: What we built into our guidance was not specific to the LOI's or orders we had coming out of the first quarter as far as those that had been pushed back or deferred.

We said even if those occurred there may be other deferrals or other things happening in the environment we are in. Rather than go order by order we built into the fact that there is some risk of that going forward in the second and third quarter.

James Parmelli/Credit Suisse First Boston: How do you track excess inventory in the channel in terms of cards already shipped?

Dick Notebaert: We do talk to customers about their deployment of what they have ordered. We do follow that closely although we don't do it in percentages you talk about. We tend to think about that as what opportunities are available for new sales and based on what they have what does that do to the weakness or strength of the next sale opportunity? The cards are being deployed and we don't track it that way. Thanks everybody and thanks for being on our call today. Thanks for listening in.

News Release

FOR IMMEDIATE RELEASE
June 19, 2001

Tellabs revises second quarter guidance

Lisle, Ill.—Tellabs today revised revenue and earnings expectations for the second quarter of 2001. Tellabs now projects second-quarter sales of about $500 million, compared with prior guidance of $780 million to $820 million. Earnings per share for the quarter are now expected to be break even before restructuring and other charges.

The dramatic changes affecting the landscape of the telecommunications marketplace have continued to impact Tellabs. Service providers are temporarily able to meet increased customer demand for bandwidth by reallocating capacity within their networks and are only buying equipment to meet the immediate needs of their customers. "While we continue to see caution from our customers in the pace of equipment deployment, our market position remains intact, and we are focused on ensuring the most profitable path through the current environment," said Tellabs President and CEO Richard C. Notebaert. "I remain confident that Tellabs has the right people, products and strategies to meet the needs of our customers and deliver future growth."

Simultaneous Webcast and Teleconference—Tellabs will host a teleconference at 4 p.m. Central time on Tuesday, June 19, 2001, to discuss second-quarter revised revenue expectations. The teleconference number is 212-231-6013. Internet users can hear a simultaneous live webcast of the teleconference at www.tellabs.com. A taped replay of the call will be available for two days, beginning at 6 p.m. Central time, at 800-633-8284. Outside of the United States, dial 858-587-5842. When prompted, enter the Tellabs reservation number: 19161649. In 80 countries around the globe, Tellabs helps the world's leading communications service providers

build tomorrow's converged networks of voice, data and video. Tellabs employees design, build and service optical networking, broadband access and voice-quality enhancement equipment. Today most telephone calls and Internet sessions in the United States flow through equipment from Tellabs (NASDAQ: TLAB; www.tellabs.com).

Forward-Looking Statements—This news release contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including statements regarding expected revenues and earnings per share. These forward-looking statements are based on currently available information and involve certain risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may differ materially from those expected. Factors that might cause such a difference include, but are not limited to, risks associated with the size and timing of product sales, customers' equipment deployment plans and budgets, new product acceptance; industry capacity; competitive products and pricing; manufacturing efficiencies, and economic changes impacting the telecommunications industry. For a more detailed description of these and other risk factors, please refer to the company's 10-K, 10-Q and other SEC filings. The company undertakes no obligation to revise or update these forward-looking statements to reflect events or circumstances after today or to reflect the occurrence of unanticipated events.

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Tellabs Operations Inc.
Revised Guidance Teleconference Call
June 19, 2001

Operator: Ladies and gentlemen, thank you for standing by and welcome to the Tellabs Operations Inc. Investor Relations Conference Call. During the presentation all participants will be in a listen only mode. Afterwards you will be invited to participate in a question and answer session. At that time, if you have a question you will need to press the "1" followed by the "4" on your telephone. As a reminder, this conference is being recorded, Tuesday, June 19, 2001. I would now like to turn the conference over to Mr. John Springer, Director of Investor Relations. Please go ahead, sir.

John Springer: Thanks, Marty and good afternoon everybody. With me today is Tellabs' President and CEO, Dick Notebaert, Joan Ryan, Executive Vice President and CFO, and Brian Jackman, President of Global Systems and Technology. If you haven't had a chance to see the news release we issued this afternoon, it is available at our website, www. tellabs.com.

Before we begin, and in keeping with the safe harbor provision of the Private Securities Litigation Reform Act of 1995, I would like to state that except for historical information, the following teleconference is based on preliminary financial results, which are subject to further review and adjustment and contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 including statements regarding expected revenues and earnings per share. These forward-looking statements are based on currently available information and involve certain risks, uncertainties, and assumptions. Should one or more of these risks or uncertainties materialize or should underlying assumptions prove incorrect, actual results may differ materially from those expected. Factors that might cause such a difference include, but are not limited to, risks associated

with the size and timing of product sales, customers equipment deployment plans and budgets, new product acceptance, industry capacity, competitive products and pricing, manufacturing efficiencies and economic changes impacting the telecommunications industry. For a more detailed description of these risk factors, please refer to the Company's 10-K and 10-Q and other SEC filings. The Company undertakes no obligation to revise or update these forward-looking statements to reflect events or circumstances after today or to reflect the occurrence of unanticipated events. With that, I will turn the call over to Tellabs' President and CEO, Dick Notebaert.

Dick Notebaert: Thank you, John. Good afternoon everyone. By this time you have had a chance to see our news release. I want to give you a look at the changing business trends as we see them through this point in the second quarter. While it is clear that the entire telecom equipment industry has been dealing with the impact of dramatic cutbacks in carrier spending and general economic uncertainty throughout 2001, the impact of these forces on orders for our products has become more pronounced during the second quarter. We have dealt with these issues in the access portion of our product portfolio since late last year.

As we exited the first quarter, we saw the initial signs of broader weakness in the form of reduced and deferred orders from our larger North American based customers late in the quarter. We heeded these signals with more conservative guidance for the second quarter. However, after two months, we are experiencing more pronounced weakness in order flow from this segment than we had anticipated. As we speak with our customers some central themes continue to emerge. First, we continue to hear caution and concern. We hear it from our customers, the very same things you read in *The Wall Street Journal* every day. The same things you see reflected in the stock market every day. Clearly, the current environment

continues to slow the pace at which our customers are deploying equipment. Second, the pace of net capacity additions in the networks of our large North American customers has slowed. This, however, runs contrary to the information we hear from our customers that end user demand for services continues to be strong. This remains a constant.

What has caused the recent disconnect between end user demand and our order patterns? It comes down to two primary drivers which taken together have had a dramatic impact on our order rates during the quarter. First, increased financial conservatism on the part of our customers means that they are no longer buying in advance of demand but are trying to align with the immediate customer need. They are working off of reserve stock as they go to just-in-time inventory and are not bulking up. Second, our larger customers are temporarily able to meet incremental end user demand by reallocating capacity within their networks. The source of this reallocation comes from capacity that had been set aside or used by alternative service providers or other potential customers. The dramatic changes in fundamentals within this carrier segment have provided a temporary source from which our larger customers can accommodate internal growth.

As a result of these issues, we are now targeting total revenue for the quarter of around $500 million. In a minute Joan will discuss more detail on our revised guidance for the quarter. Before I turn the call over to her, let me share with you a bit of perspective and separate the incremental changes of the current environment from Tellabs' longer-term competitive position. While we are not providing specific guidance beyond the second quarter today, based on what we see now, we anticipate several more challenging quarters ahead as the industry digests the impact of the issues that I have already mentioned. Let me reiterate, however, the conversations with customers which indicate continued healthy end user demand

for the services Tellabs' products help deliver. Our customers remain committed to Tellabs' products as the means to deliver these services. Our market share positions are intact. This is important as we are at the beginning of an exciting new product cycle with our TITAN 6000 series. We will recognize our first revenue from these products in the second quarter. As customers confirmed recently at SuperComm, interest in and demand for these new products remains strong and we are aggressively ramping capacity to meet the demand we see. These two products, as well as the TITAN 6700, which shipped last week for its first field trial will bring substantial top line growth drivers to the Tellabs' product portfolio.

Despite the current challenges, we are as confident as ever in Tellabs' long-term prospects. We have extraordinarily deep relationships with our customers, which are predominantly the larger North American carriers. We have a solid financial foundation from which to operate. We are in the initial stages of an exciting new product cycle that significantly enhances our product line breadth and increases our addressable market. That is a good position to be in. It has never been more important than it is today. In addition, our business outside of North America or outside the United States continues to perform well. With that, let me turn it over to Joan.

Joan Ryan: Thank you, Dick. Good afternoon everyone. Let me start by giving you the details of our revised guidance for the second quarter. This guidance excludes the restructuring and other one-time charges of $262 million, which we announced at the end of May as well as the incremental goodwill from the Future Networks acquisition. In terms of revenue, we now expect second quarter total revenue to be around $500 million. The approximate breakdown by product area is as follows: we expect to realize about $210 million in operating optical network revenues, approximately $150 million in broadband access revenues, about $40 million in

voice quality enhancement revenue and approximately $100 million in professional services revenues.

Due to a material shift in revenue mix across our product group as well as lower shipment volumes through our manufacturing plants, we now see our second quarter gross margins to be in the low 40% range. However, let me note that we continue to see stable pricing trends across all of our products.

Reflecting both the restructuring we announced last quarter and the continued focus on cost control throughout the organization, total operating expenses for the second quarter are now expected to be sequentially lower at around $225 million, which is below the $240 million previous guidance we provided to you in April.

Second quarter earnings per share excluding restructuring and other one-time charges as well as the dilution associated with the Future Networks acquisition are now expected to be at around breakeven. On a reported basis, which means including restructuring and other one-time charges along with the $.01 per share dilution related to the FNI acquisition, Tellabs will show a quarterly loss of approximately $.45 per share.

With respect to the remainder of 2001 given that the timing and extent of this industry wide adjustment is unclear, we will refrain from giving specific guidance beyond the second quarter at this time. While we clearly face challenge in the near term, Tellabs is focused on the most profitable path with the current carrier spending environment. Supplementing Tellabs' traditionally strong balance sheet we are beginning to see improvements in our operating expenses as a result of the actions we rapidly undertook in the first quarter to recalibrate our cost structure.

We will continue to closely examine our cost structure going forward with the goal of maximizing profitability while of

course balancing the need to continue investing in areas that drive future growth. At this point, we will open the floor to your questions. I would like to ask you to limit this to 30 minutes, which is the duration of our call. We have about 15 minutes for questions. You will have ample time to ask detailed questions when we announce in mid-July. Marty, we are now ready for the very first question.

Operator: Thank you. Ladies and gentlemen, if you wish to register for a question for today's question and answer session, you will need to press the "1" followed by the "4" on your telephone. You will hear a three-tone prompt acknowledging your request. If your question has been answered and you would like to be removed from queue, press "1" followed by "3" on your touchtone phone. If you are using a speakerphone, please pick up the handset before pressing the numbers. One moment please for the first question.

Paul Silverstein/Robinson Stevens: Can you talk if any of the 210 in optical was from the 6500 product or is expected to be in the 6500 product?

Joan Ryan: Yes it did. That is actually from the full TITAN 6000 series and we expect to generate first revenue and the amount is $13 million. It is a combination of the 6500 and the 6100.

Paul Silverstein/Robinson Stevens: In terms of customers, is the 6500 still at one customer account or has that changed?

Dick Notebaert: It is still at one. We are recognizing revenue at one customer.

Paul Silverstein/Robinson Stevens: Are you shipping to more than one customer?

Dick Notebaert: Yes we are.

Paul Silverstein/Robinson Stevens: You are shipping to more than one but haven't recognized revenue?

Dick Notebaert: That is correct.

Steve Levy/Lehman Brothers: On the long-term operating model, if you look at this typically in the days of IPO's of companies with long-term operating model assumptions in terms of profitability and maybe you can qualitative or quantitative describe where you would expect to be at the end of 2002 or maybe 2003 on a long-term operating model basis. Would you expect there are any other write-offs or charges beyond the $262 million you already outlined?

Dick Notebaert: Let me take the second question first. Right now we do not expect any significant write-offs that would call for an announcement similar to what we did. On the first question I will ask Joan or John to answer that. We do have a long-term model.

Joan Ryan: We have always used our mantra as 30/30 and at this point and when we entered the year we had thought that was what we would achieve for this year. I think at this point given the lack of visibility and not understanding completely the extent or timing of this industry wide adjustment, I don't think we are prepared to talk about that. We do see the outlook to be strong for Tellabs relative to our position. We talked about our new products and the exciting new product cycle we are entering and our strong financial foundation, which will enable us to continue to invest going forward for our business.

Dick Notebaert: I read what you have written and I read what other people have said and if you look out at where we go after this burning off capacity, I think you see us getting back on the where we have been as far as earnings go. The 30/30 model may not hold in '02 because it will depend on where we come out of this thing. What we have going for us and what we all feel very optimistic about as a Company is the 6000 series and traction it is getting with customers. We would have liked to have recognized more revenue but it looks like we are getting a pretty good take on the product.

Paul Silverstein/Robinson Stevens: What I was really trying to get to was operating profitability and obviously nobody has been good at forecasting the revenues but we can take a guess at that but in terms of right sizing the organization and get to some situation at the end like '02 or maybe even early '03, do you think you will get back to the old operating margins?

Dick Notebaert: You are damn straight, yes. What Brian has done in his shop and what John Kohler has done in his shop and what we have done across the board will place us in that right position. We absolutely believe we will be in the exact right spot to return the type of earnings and net income we have had. Thanks for the question. Thanks for clarifying it, Steve.

Michael Davies/Lands Berg Tallman: Can you give us an idea of where you see the spending coming from and what the errantry of revenue is coming into the quarter here? Is it from the incumbents or can you give us color on that?

Dick Notebaert: If you look at the spending, it appears to be coming from larger customers which is what we would expect it would come from. There is still extreme softness and consolidating of their efforts and being under even more financial pressure. We have all read about some of that in the media so I am not saying anything you all haven't read. As far as the quarter goes, if you look at the two and a half months that the quarter has gone, it has not seen the usual spike you would see in the third month of the quarter. It has, in fact, been more steady state for us.

Brian Jackman: I would reaffirm that. I think as far as sectors, I think we have felt that the wireless sector has held up pretty well and our international business has held up pretty well. So on a relative basis, I think those are the areas that have been the least disappointing. We are seeing pullback on the part of larger carriers even though we think we are still getting our share or more and their absolute level of spending has been reduced.

Dick Notebaert: I think that is important. Outside the United States our performance has been in the range of our plan and we felt pretty good about the traction and what the guys are doing outside the U.S. and the buying pattern of those customers. We have not seen softness there yet. In fact, that is a bright spot for us.

P*aul Fortsbach/J.P. Morgan H&Q:* This is Paul for Jim Lipton. Looking at our model, it appears there is a significant amount of softness in the TITAN 6500 and can you give us an idea if the pullback is more in chassis initial deployment or in additional expansion of already deployed systems?

Brian Jackman: I don't know at this stage of the quarter. We have a fine cut on that. I would speculate now that it has been pretty evenly spread. We are in the process of doing a large number of installations of frames we shipped late last year during the first quarter and so to a certain degree that has probably slowed down the shipment of new systems because the customers themselves are asking that we get the previously ordered systems in place before they generate new orders. I think there has been a pullback on orders for plugs as well as they work down the inventory in their big centers.

Dick Notebaert: I think it is pretty even across the board. I agree with Brian. We have just seen that part of our product line just be in general soft. There are a lot of products in our industry where you see the same thing—great products like the 5500 where things have just slowed.

Brian Jackman: I mean that lag is normal. It is not atypical for a large carrier to have the time interval of three to six months between the time a system is shipped and the time it starts to be turned up and fully provisioned for service. Some of this is normal. What is not normal is the anticipation of what they will need in the next couple of quarters. Like us, I think they are worried about this ability.

Jeff Meyers/Ivory Capital: Can you delineate between the IXC's and the RBOC's and if you have seen reallocation of capacity which originally was intended for CLEC's?

Dick Notebaert: I think it has been pretty even across the board. I don't think you can differentiate. At this point we don't have the final numbers in where we do it by company or by segment. I think the large service providers have been pretty even as we look at it across the board. Obviously we have gotten good traction with the 6500 from local exchange carriers and so we feel pretty good about that.

Operator: Ladies and gentlemen as a reminder, if you do have a question, please press "1" followed by "4" on your telephone pad. I have a follow-up question from Paul Silverstein from Robinson Stevens. Please go ahead sir.

Paul Silverstein/Robinson Stevens: Thanks very much. Can I ask you to revisit the linearity question and give us more detail in terms of what you saw during the quarter and whether this is trends worsening dramatically as you went from the first month toward June and also if you can talk about where we should expect expenses to go going forward?

Dick Notebaert: I will try it again. Come back at me here if I don't get to the heart of your question. If we took this quarter and the three periods of the quarter and compared it to prior quarters, same period last year or sequential quarters, what you would find is we came out and had a bit of a burst in the first part of the quarter and an up tick. Then it softened and everything is relative. In the last couple of weeks, the last week or six days ago, we have seen an up tick again. I will tell you that it has not been the type of up tick that we would have had in the past. In the past it would have been a staircase where you would have been pretty good in the first period and even better in the second period and then really good in the third period of a given quarter. Does that answer the linearity question?

Paul Silverstein/Robinson Stevens: Yes it does.

Joan Ryan: I can answer that as well. What we started to see at the end of the first quarter in March, which was a very abrupt change and it was even deep and further as we moved through the second quarter hence, the shortfall vs. where we thought we were going to be. Another phenomena is while we were getting orders there was also the tendency on a more accelerated basis than we have seen in the past of customers placing an order and then later scheduling it out for a future date or reducing the order altogether. It has been somewhat erratic in terms of that and I think again it comes back to our customers evaluating what their needs are within the network and being very judicious around their spending and only spending when they absolutely have to and increasing their network utilization rates and redeploying the capacity for CLEC interconnection and things like that. While they have been going through that process during the quarter we have been seeing the effects. Again, as we mentioned before, end user demand for the equipment we provide does appear to be relatively strong albeit lower than it was last year during the boom time.

Paul Silverstein/Robinson Stevens: When you talk about erratic customer behavior, is there a growing trend toward push out and cancellation or was it bouncing around during the quarter?

Joan Ryan: I guess it would be somewhat not on an even pattern, let's put it that way.

Dick Notebaert: What we are talking about here is the fact that in the past it was very predictable you know like going up a staircase for us.

Paul Silverstein/Robinson Stevens: On the expense side, what can we expect going forward for the second half of this year?

Joan Ryan: We are not going to be giving forward guidance in detail at this point in time as I mentioned earlier in my comments. We were in the $240 million range in the first quarter and our expectation is to be around $225 million. So our overall goal was to maintain that first quarter run rate while at the same time we are very focused on several areas. One is all discretionary spending, which continues, and a focus on product cost reductions and realigning manufacturing capacity with lower revenue growth, which is something we are doing on an ongoing basis. We are also focusing R&D to those areas that drive growth and then process improvements as they relate to manufacturing efficiency and overall productivity, which is an initiative we have in place all across the organization and continue to stay focused on.

Paul Silverstein/Robinson Stevens: Given what you just said, is it correct that beyond driving efficiencies in the organization you are not planning on downscaling the organization given the run rate?

Joan Ryan: As of today what we said was that we are in the process of evaluating our cost structure, which is an ongoing process.

Dick Notebaert: Marty, we will take one more question.

Michael Bruno/Warshtech.com: I would like to get an idea on how big your workforce is now and what sort of staff reductions you think will be happening?

Dick Notebaert: First of all, we did a restructuring of the Company and we put those numbers out at the end of the quarter. We are not hiring. We are treading and will continue to drive it down. We are in that 8,000 range of employees.

Michael Bruno/Warshtech.com: Do you have a target figure in mind of what you would like to be at?

Dick Notebaert: Not that we are going to give you today. Thanks everybody. Thanks for being on the call. We appre-

ciate your time. I personally look forward to having one of these calls where there is a lot of good news on it. Thank you very much.

Operator: Ladies and gentlemen that does conclude your conference for today. We thank you for your participation and ask that you please disconnect your line.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

[Filed JUL 11, 2003]

Case No. 02-CV-4356
Judge Amy St. Eve
Jury Trial Demanded

THOMAS JOHNSON, Individually and On Behalf of All Others Similarly Situated,

Plaintiff,

vs.

TELLABS, INC., *et al.*,

Defendants.

SECOND CONSOLIDATED AMENDED CLASS ACTION COMPLAINT

Plaintiffs, through their attorneys, bring this action on behalf of themselves and all other persons similarly situated, on personal knowledge as to themselves and their own activities, and as to all other matters, based upon the investigation of Plaintiffs' counsel, which included, among other things: (i) interviews of former employees of Tellabs, Inc. ("Tellabs" or the "Company") and other persons with knowledge and information concerning the matters alleged herein, including Confidential Sources 1 through 27, described below; (ii) review and analysis of the public filings of Tellabs, including its filings with the Securities and Exchange Commission ("SEC"); and (iii) review and analysis of news articles, press releases, and analysts' reports by or relating to Tellabs. Plaintiffs believe that further evidentiary support for the allegations set forth below will exist after a reasonable opportunity for discovery.

CONFIDENTIAL SOURCES

Confidential sources (also referred to as "CS-_") who provided information for Plaintiffs' counsel's investigation included the following:

- CS-1: Confidential Source 1 is a former Tellabs marketing. manager, from several months prior to the Class Period through substantially after the Class Period.
- CS-2: Confidential Source 2 is a former Tellabs executive account manager and regional manager, from substantially prior to the Class Period through several months after the Class Period.
- CS-3: Confidential Source 3 is a former high-level Tellabs sales executive, from many years prior to the Class Period through shortly prior to the Class Period.
- CS-4: Confidential Source 4 is a former Tellabs shipping supervisor, from many years prior to the Class Period through shortly after the Class Period.
- CS-5: Confidential Source 5 is a former mid-level Tellabs employee involved in distribution, from well prior to the Class Period through substantially after the Class Period.
- CS-6: Confidential Source 6 is a former Tellabs senior business manager, from prior to the Class Period through well after the Class Period.
- CS-7: Confidential Source 7 is a former Tellabs sales director, from prior to the Class Period through most of the Class Period.
- CS-8: Confidential Source 8 is a former Tellabs marketing manager, from well prior to the Class Period through well after the Class Period.

- CS-9: Confidential Source 9 is a former Tellabs project manager, from close to the beginning of the Class Period through after the Class Period.
- CS-10: Confidential Source 10 is a former Tellabs customer accounts representative, from substantially prior to the Class Period through well after the Class Period.
- CS-11: Confidential Source 11 is a former Tellabs regional sales director, from substantially prior to the Class Period through shortly after the Class Period.
- CS-12: Confidential Source 12 is a former Tellabs installations supervisor, from the beginning of the Class Period through after the Class Period.
- CS-13: Confidential Source 13 is a former Tellabs sales manager, from substantially prior to the Class Period through the end of the Class Period.
- CS-14: Confidential Source 14 is a former Tellabs materials manager, from substantially prior to the Class Period through the end of the Class Period.
- CS-15: Confidential Source 15 is a former Tellabs manager in the business development area, from prior to the Class Period through after the Class Period.
- CS-16: Confidential Source 16 is a former Tellabs marketing strategy executive, from prior to the Class Period through after the Class Period.
- CS-17: Confidential Source 17 is a former Tellabs market analyst, from well prior to the Class Period through shortly after the Class Period.
- CS-18: Confidential Source 18 is a former high-level SALIX/Tellabs operations executive, from prior to the Class Period through the end of the Class Period.

- CS-19: Confidential Source 19 is a former high-level Tellabs sales executive, from before the Class Period through after the Class Period.
- CS-20: Confidential Source 20 is a former high-level Tellabs sales executive, from well before the Class Period through shortly after the Class Period.
- CS-21: Confidential Source 21 is a former Tellabs sales director, from well before the Class Period through well after the Class Period.
- CS-22: Confidential Source 22 is a former Tellabs operations manager, from shortly prior to the Class Period through after the Class Period.
- CS-23: Confidential Source 23 is a former Tellabs engineer who held a variety of management positions at Tellabs, from well prior to the Class Period through well after the Class Period.
- CS-24: Confidential Source 24 is a former Tellabs senior designer, from prior to the Class Period through well after the Class Period.
- CS-25: Confidential Source 25 is a former Tellabs customer manager, from prior to the Class Period through well after the Class Period.
- CS-26: Confidential Source 26 is a former Tellabs team project manager for a product distributor to Tellabs, from prior to the Class Period through after the Class Period.
- CS-27: Confidential Source 27 is a former Tellabs consultant who worked for value added resellers ("VARS"), before and throughout the Class Period. VARS are third parties that work along with Tellabs to handle customer services, including engineering site surveys, installations, and testing services. VARS also act as distributors of Tellabs' products and provide other services.

NATURE OF THE ACTION

1. Plaintiffs bring this securities class action on behalf of themselves and on behalf of all persons who purchased the common stock of Defendant Tellabs during the period from December 11, 2000 through June 19, 2001, inclusive (the "Class Period").

2. During the relevant period, Tellabs designed, manufactured, marketed, and serviced optical networking, broadband access, and voice-quality enhancement solutions. The Company also provided professional services that supported its solutions. Tellabs' products and services were used worldwide by providers of communications services. The Company's products were sold in the domestic and international marketplaces through the Company's field sales force and selected distributors. The Company's customer base included incumbent local exchange carriers, independent telephone companies, interexchange carriers, local telephone administrations, other local exchange carriers, original equipment manufacturers, cellular and other wireless service companies, cable operators, alternate service providers, competitive local exchange carriers, internet service providers, system integrators, government agencies, and business end-users. During the Class Period, Tellabs counted as customers telecommunications giants SBC Communications, Inc. ("SBC") and Verizon Communications, Inc. ("Verizon").

3. By early- to mid-2000, the Internet and telecommunications sectors were contracting significantly. In the face of this dramatic slowdown and consolidation in the telecommunications sector, Defendants falsely reassured public investors, in a series of statements made during the Class Period, that Tellabs was continuing to enjoy strong demand for its products and earning record revenues. These unqualified, positive statements, for which Defendants had no reasonable basis, had the effect of artificially inflating and maintaining the trading price of Tellabs stock. At the same

time they were falsely assuring the investing public concerning the Company's performance and prospects, Tellabs insiders profited by selling tens of thousands of shares of their personally-owned Tellabs common stock at artificially inflated prices, reaping proceeds of over $8 million.

4. In truth, and unbeknown to the investing public, by no later than the beginning of the Class Period, Tellabs' performance was being adversely affected by the same difficult telecommunications business environment that its competitors had been facing for several months. Tellabs' customers, which were telecommunications-related companies, were suffering from a severe deterioration and consolidation of their businesses. Accordingly, demand for Tellabs' products was slowing.

5. In addition to issuing a series of deceptive statements and inflated earnings guidance, Defendants sought to falsely assure investors as to Tellabs' performance and prospects by means of a number of deceptive practices that artificially inflated the Company's reported revenues and concealed the rapidly falling demand for the Company's key products. Such fraudulent practices included channel stuffing, which artificially boosted revenues in earlier periods at the expense of subsequent periods; phony sales; and offering customers excessive and unusual discounts, rebates, payment terms, rights of return, and other incentives that went beyond ordinary business practices, none of which were disclosed to the investing public. Channel stuffing is the deceptive business practice of building inventories of distributors and customers, before they would have purchased such products in the ordinary course, to artificially inflate sales and earnings. Stuffing the channel has the effect of robbing future quarters to boost sales in the current quarter.

6. As a result of Defendants' deceptive conduct during the Class Period, the price of Tellabs stock climbed as high as $67.125 per share (on February 5, 2001).

7. Defendants' efforts to obscure and conceal the truth concerning Tellabs' deteriorating sales and diminishing value continued until, at the earliest, June 19, 2001, when Tellabs finally conceded that demand for its products had collapsed, and substantially lowered its second quarter guidance, reducing expected revenues from the $780 million to $820 million range to only $500 million. In response, on June 20, 2001, Tellabs common stock fell, on record volume, from a closing price of $21.20 per share the previous day to close at $16.04 per share—a one-day decline of more than 24%. The overall decline from the inflated Class Period high of $67.125 per share to the low on June 20, 2001 of $15.87 per share was *more than 76%.*

8. As a result of the foregoing, Plaintiffs and other purchasers of Tellabs common stock during the Class Period suffered substantial damages because the market price of the stock they purchased was artificially inflated by Defendants' material misrepresentations and omissions and did not reflect the true value of the stock.

JURISDICTION AND VENUE

9. The claims asserted herein arise under and pursuant to Sections 10(b), 20(a), and 20A of the Securities Exchange Act of 1934 (the "Exchange Act") [15 U.S.C. §§ 78j(b), 78t(a), and 78t-1], and Rule 10b5 promulgated thereunder by the SEC [17 C.F.R. § 240.10b-5].

10. This Court has jurisdiction over the subject matter of this action pursuant to Section 27 of the Exchange Act [15 U.S.C. § 78aa] and 28 U.S.C. §§ 1331 and 1337.

11. Venue is proper in this District pursuant to Section 27 of the Exchange Act, and 28 U.S.C. § 1391(b). All or a substantial part of the acts charged herein, including the preparation and dissemination of materially false and misleading information, occurred in this District and Tellabs

maintains its chief executive offices and principal place of business within this District.

12. In connection with the wrongs complained of herein, Tellabs, directly or indirectly, used the means and instrumentalities of interstate commerce, including the United States mails and interstate telephone communications, and the facilities of the national securities markets.

THE PARTIES

Plaintiffs

13. On September 27, 2002, the Court appointed Makor Issues & Rights Ltd. ("Makor") Lead Plaintiff pursuant to 15 U.S.C. § 78(u)-4. Makor purchased Tellabs common stock at artificially inflated prices during the Class Period and was damaged thereby.

14. Additional Plaintiffs are the following individuals who also purchased Tellabs common stock at artificially inflated prices during the Class Period and were damaged thereby:

a. Chris Broholm

b. Richard LeBrun

c. David Leehey

d. Patricia Morris

15. Certifications for Plaintiffs previously were submitted to the Court.

Defendants

16. Defendant Tellabs is a Delaware corporation with its principal executive offices located at One Tellabs Center, 1415 West Diehl Road, Naperville, Illinois 60563.

17. Defendant Michael J. Birck ("Birck") has been a Tellabs Director since 1975 and has served as Chairman of

the Board since September 18, 2000. Birck served as Tellabs' Chief Executive Officer and President from 1975 through September 1, 2000, and was a founder of the Company. During the Class Period, while in possession of adverse undisclosed information about the Company, Birck sold 80,000 shares of common stock for $5,183,150 in illegal insider trading proceeds.

18. Defendant Brian J. Jackman ("Jackman") has served as a Tellabs Director since 1993. He served as Tellabs' President of Global Systems and Technology and Executive Vice President from 1998 to September 1, 2001. As President of Global Systems and Technology at Tellabs, Jackman was responsible for all product divisions worldwide.

19. Defendant John C. Kohler ("Kohler") served as Tellabs' Senior Vice President of Global Business Operations (Global Manufacturing) from February 2000 to March 10, 2003, and was Tellabs' Vice President of Global Manufacturing from 1992 - 2000. During the Class Period, Kohler was in charge of manufacturing, including procurement, manufacturers, repairs, returns, warehousing, the building and storage of products, and the purchase of parts. During the Class Period, while in possession of adverse undisclosed information about the Company, Kohler sold 7,500 shares of common stock for $484,968 in illegal insider trading proceeds.

20. Defendant Richard C. Notebaert ("Notebaert") served as a Tellabs Director from April 19, 2000 to June 17, 2002, and as Chief Executive Officer and President of Tellabs from September 18, 2000 to June 17, 2002,

21. Defendant Robert W. Pullen ("Pullen") served as Tellabs' Senior Vice President and General Manager of Optical Networking from August 2000 to February 2, 2002, and, in that capacity, had responsibility with respect to the TITAN series products at issue in this action.

22. Defendant Joan E. Ryan ("Ryan") served as Tellabs' Executive Vice President and Chief Financial Officer from February 2, 2000 to February 7, 2003.

23. The Individual Defendants, as senior executive officers and directors of Tellabs, were controlling persons of the Company, at all relevant times. Each exercised his power and influence to cause Tellabs to engage in the fraudulent practices complained of herein.

24. It is appropriate to treat the Individual Defendants as a group for pleading purposes and to presume that the materially false, misleading, and incomplete information conveyed in the Company's public filings, press releases, and other public statements, as alleged herein, are the collective actions of the narrowly defined group of Defendants identified above. The above officers and directors of Tellabs, by virtue of their high-level positions with the Company and "hands on" management style, directly participated in the management of the Company, were directly involved in the day-to-day operations of the Company at the highest levels, and were privy to confidential proprietary information concerning the Company. Said Defendants were involved in the fraudulent activities herein alleged and were also involved in drafting, producing, reviewing, and disseminating the materially false and misleading statements and information alleged herein; were aware, or recklessly disregarded, that the materially false and misleading statements were being issued regarding the Company; and approved or ratified these statements, in violation of the federal securities laws.

25. As officers and directors and controlling persons of a publicly-held company whose common stock was, and is, registered with the SEC pursuant to the Exchange Act, and governed by the provisions of the federal securities laws, the Individual Defendants each had a duty to disseminate promptly accurate, complete, and truthful information with respect to the Company and to correct any previously-issued

statements that had become materially misleading or untrue, so that the market price of the Company's publicly-traded securities would be based upon truthful, complete, and accurate information. The Individual Defendants' misrepresentations and omissions during the Class Period violated these specific requirements and obligations.

26. The Individual Defendants participated in the drafting, preparation, and/or approval of the various public statements and filings complained of herein and were aware of, or were severely reckless in disregarding, the misstatements contained therein and omissions therefrom, and were aware of, or recklessly disregarded, their materially false and misleading nature. Because of their Board membership and executive and managerial positions with Tellabs, and "hands on" management of the Company, the Individual Defendants had access to the adverse undisclosed information about the Company and knew, or were severely reckless in not knowing, that these adverse facts rendered the positive representations made, issued, or adopted by the Company materially false and misleading.

27. The Individual Defendants, because of their positions of control and authority as officers and directors of the Company, were able to and did control the content of the various SEC filings, press releases, and other public statements pertaining to the Company during the Class Period. Each Individual Defendant was provided with copies of the documents alleged herein to be misleading prior to or shortly after their issuance and had the ability and opportunity to prevent their issuance or cause them to be corrected. Accordingly, each of the Individual Defendants is responsible for the accuracy of the public reports, releases, and statements detailed herein and is therefore primarily liable for the misrepresentations and misleading statements contained therein.

28. Each of the Defendants is liable as a primary participant in a fraudulent scheme and course of business that

operated as a fraud and deceit on purchasers of Tellabs common stock, by disseminating materially false and misleading statements and concealing material adverse facts. The scheme: (1) deceived the investing public as to the true value of Tellabs common stock; and (2) caused Plaintiffs and other members of the Class to purchase Tellabs common stock at artificially inflated prices that did not reflect its true value.

TELLABS PRODUCTS AT ISSUE

29. During the Class Period, Defendants' misleading statements and activities related to Tellabs' flagship TITAN 5500 systems, and two purportedly newly-launched products, the TITAN 6500 and SALIX 7750.

30. TITAN 5500: In 2000, optical networking systems accounted for approximately 64% of Tellabs' sales, and the TITAN 5500—Tellabs' principal seller in this category—was the Company's "flagship," according to Tellabs' 2000 Form 10-K. Tellabs' 2000 Annual Report explains that its TITAN 5500 systems are "digital cross-connect systems" —optical networking products that "help direct different types of communications traffic across wired and wireless networks." Tellabs' 2000 Annual Report describes a "digital cross-connect" as "[a] specialized high-speed data channel switch, which connects transmission paths based on network needs (rather than call by call). Digital cross-connects manage and route network traffic, and combine, consolidate and segregate signals to maximize efficiency." According to the 2000 Annual Report, features of the TITAN 5500 include access, transport, and management for fiber optic networks. Fiber optic networks are a critical part of overall voice and data communications infrastructures. Tellabs' 2000 Annual Report identified the TITAN 5500 systems as Tellabs' "core products."

31. TITAN 6500: According to Tellabs' 2000 Annual Report, the TITAN 6500 is a new "multiservice transport

switch" that "emerged from [Tellabs'] laboratories in 2000." "Multiservice" means capable of simultaneously transporting a variety of signal types.

32. SALIX 7750: According to Tellabs' 2000 Annual Report, the SALIX 7750 ("SALIX") is a "next-generation switch" that "enables service providers to move voice traffic seamlessly onto data networks while supporting voice services such as three-way calling and messaging." Tellabs' 2000 Annual Report, describes a "next-generation switch" as one that "performs advanced data switching in addition to the same features as local central office and tandem long-distance switches."

TELLABS' CUSTOMERS

33. During the Class Period, Tellabs' largest customer for its "flagship" Titan 5500, and largest customer overall was Verizon. SBC was also one of Tellabs' most significant customers. Tellabs' 2000 Form 10-K stated:

> In 2000, sales to Verizon Communications, Inc. (Verizon) accounted for approximately 19.1% of consolidated net sales. In 1999, sales to SBC Communications, Inc. (SBC) and sales to Verizon accounted for approximately 11.5% and 11.0% of consolidated net sales, respectively. In 1998, sales to Verizon and SBC accounted for approximately 13.9% and 12.6% of consolidated net sales, respectively. No other customer in 2000, 1999, or 1998 accounted for more than 10% of consolidated net sales.

CS-11, CS-12, CS-14, and CS-22 confirmed that Verizon was Tellabs' largest customer for the TITAN 5500 in 2000 and 2001. Tellabs often sells its products through distributors. CS-11 confirmed that Tellabs' largest distributors, during the Class Period, were Telcobuy.com, Lexicom, and Walker Communications, Inc.

TELLABS' DEMAND AND PRODUCT PROBLEMS—AND DEFENDANTS' DECEPTIVE PRACTICES TO CONCEAL THOSE PROBLEMS

Demand For The TITAN 5500 And Other Tellabs Products Fell In 2000-2001

34. Contrary to Defendants' public representations during the Class Period, as detailed below, and unbeknown to investors, by the beginning of the Class Period, at the end of 2000, demand for Tellabs' key products, including the TITAN 5500—Tellabs' "best seller"—was slowing substantially. Thus:

35. A Tellabs installations supervisor, CS-12, related that, in late 2000, there was a significant reduction (roughly 25%) in orders for the TITAN 5500 from Verizon (Tellabs' largest customer). Moreover, CS-22, a former Tellabs operations manager, reported that, in January 2001, orders from Verizon significantly declined by roughly 50%, because Verizon was overloaded with TITAN 5500 products.

36. According to CS-13, a Tellabs sales manager, customers in Latin America and Central America did not want the TITAN 5500.

37. CS-14, a Tellabs materials manager who was at Tellabs throughout the Class Period, reported that orders from every single TITAN 5500 customer declined while CS-14 was at Tellabs.

38. CS-15, a Tellabs manager in the business development area, related that sales of Tellabs' products were declining by early 2001. CS-15 also reported that customers believed Tellabs products to be of poor quality.

39. A former Tellabs marketing strategy executive, CS-16, reported that a study performed for Tellabs by an independent research firm, Probe Research, which cost Tellabs $100,000, and was completed in or about early 2001,

showed a steep drop in the number of T1 circuits required in the market. CS-16 explained that T1's were the main source of demand for Tellabs' TITAN 5500 systems. In or about early 2001, an internal report was prepared by Tellabs' marketing strategy department that accurately concluded that, as a result of the decline in T1's, Tellabs' revenue from the TITAN 5500 would decline by approximately $400 million (a huge and extremely significant decline given that, in the same time frame, the TITAN 5500 accounted for approximately $1.8 billion to $2.0 billion of Tellabs' approximately $3.4 billion of reported revenue in 2000 and that Tellabs had no other products to take up the slack). According to CS-16, this report was discussed at marketing strategy meetings, and was widely circulated to at least 10 executives, including individuals who reported directly to Defendants (such as Harvey Scull, the head of the marketing strategy department, who reported directly to Defendant Birck).

40. Tellabs' internal quarterly reports—prepared by Tellabs' finance department and viewed by CS-23—showed declining demand in the third and fourth quarters of 2000 for a variety of Tellabs' products, including the TITAN 5500, Tellabs' most significant product. Quarterly reports concerning the profitability of Tellabs' merchandise, which could be accessed on the Tellabs database system, showed a decline in customer demand for the TITAN 5500 in March 2001, according to CS-17.

41. According to a former Tellabs customer manager, CS-25, Tellabs' customers were not buying as early as November 2000 and Tellabs was not busy throughout the Class Period. According to CS-25: "it got slower and slower."

42. Former Tellabs marketing manager CS-1 confirmed that Tellabs had excess TITAN 5500s on hand in late 2000 / early 2001 due to lack of customer demand because Tellabs had overloaded its customers.

43. Former Tellabs executive account manager CS-2 confirmed that, due to Verizon budget cuts, including cuts in capital expenditures and other expenditures affecting network equipment purchases from companies such as Tellabs during the fourth quarter of 2000 and throughout 2001, Verizon failed to execute millions of dollars of projected TITAN 5500 orders, including new systems, plugs, and cards.

44. The decline in demand also was confirmed by a major distributor of parts to Teilabs. According to CS-26, a Tellabs team project manager for a product distributor to Tellabs, Tellabs suddenly stopped taking parts for its products in the beginning of 2001. The parts distributor thought Tellabs knew it was in trouble by about February 2001. By early April 2001, the distributor started having problems obtaining payment from Tellabs, resulting in a mounting debt that reached $10 million over the next six months.

45. According to CS-1, Tellabs had "tons" of excess TITAN 5500s and other products on hundreds of racks in Tellabs' Bollington warehouse. Some systems were there for six months to a year. Former Tellabs marketing manager CS-1 also confirmed that Tellabs had excess TITAN 5500s on hand in late 2000 / early 2001 due to lack of customer demand, resulting from Tellabs overloading its customers.

Contrary to Defendants' Portrayal, the TITAN 6500 Suffered From Weak Demand, Weak Customer Acceptance, Severe Development Delays, and Failed Customer Trials

46. As detailed below, during the Class Period, Defendants touted Tellabs' TITAN 6500 while failing to disclose to investors that these products were not being accepted or purchased by customers, were way behind in development, were failing evaluations, had defects that would not be resolved until well after the Class Period, and were not even close to being saleable products until significantly after the Class Period. Individual Defendants were directly involved

with these issues, including visiting customers to deal with the TITAN 6500's problems. For example:

47. CS-16, a former Tellabs marketing strategy executive, related that customers thought that Tellabs' TITAN 6500 products had "too big a footprint" (took up too much space) in comparison to the amount of bandwidth capacity the products had. Customers explained that competitor Ciena's product provided more bandwidth for the amount of floor space Tellabs' TITAN 6500 took up. CS-16 related that Tellabs repeatedly attempted, without success, to sell its TITAN 6500 to major customers Verizon, BellSouth, and SBC.

48. According to CS-19, a former high level Tellabs sales executive, Tellabs did not do much with the TITAN 6500, and, by October 2001, some four months after the close of the Class Period, there had been only a couple of trials in a couple of locations. According to CS-5, who was involved in Tellabs distribution, Tellabs did not make actual sales of the TITAN 6500 or even have the product in its warehouse until after mid-September 2001. Similarly, according to a former Tellabs project manager, CS-9, Tellabs played up the TITAN 6500 when it had not actually sold one yet; and the TITAN 6500 was still *not* a released, saleable product even two months *after* the end of the Class Period. Former Tellabs consultant CS-27 also confirmed that the TITAN 6500 was not approved by the RBOCs (Regional Bell Operating Companies).

49. CS-6 confirmed that, at least since September 2000, Sprint network traffic had been dropping, and thus demand for the TITAN 6500 product was dropping. According to CS-6, the TITAN 6500 was meant for very high bandwidth, and the customers needed to have growth to support it; consequently, Sprint decreased its orders after an initial deal that Defendants touted.

50. In addition, according to CS-1, a former Tellabs marketing manager, senior management, including Defendant Pullen (then Senior Vice President of Product Development), was aware of TITAN 6500 production problems and that the product was failing evaluations. Moreover, as CS-1 reported, Pullen made numerous visits to TITAN 6500 customers in connection with failed evaluation problems.

51. According to former Tellabs executive account manager, CS-2, Tellabs executives got very aggressive with trying to push the TITAN 6500 (including pushing sales personnel to do everything they could to sell the product) and they just did not have a product. CS-2 never closed any sales of the TITAN 6500. CS-2 also explained that Tellabs was having a very difficult time testing the TITAN 6500; and that, in the fourth quarter of 2000 and first quarter of 2001, Tellabs product managers stated they were in the process of fixing the TITAN 6500's defects and hoped to release the product in the first quarter of 2002.

52. As CS-3, a high-level Tellabs sales executive, explained, the TITAN 6500 was almost two years late to market, which annoyed customers and resulted in Tellabs probably losing $50 million to $60 million of initial sales that it would have had if the product had been on time. Due to the lateness of Tellabs' product, it lost business to a French competitor, Alcatel, even though Alcatel had an inferior broadband cross-connect product, according to CS-3.

53. According to CS-3, the slow pace of development of the TITAN 6500 was evident throughout the entire development process in 1998, 1999, 2000, and 2001, and thereafter. Defendants Jackman and Pullen, who were both actively involved in product development, and other development personnel knew that the TITAN 6500 was not ready for disbursement despite Defendants' public announcements, according to CS-3. As explained by CS-3, Tellabs introduced the TITAN 6500 in 2000 prior to its being ready; however,

customers realized that the TITAN 6500 "was not even close to being ready" when they evaluated it in their labs. According to CS-3, Notebaert also knew about the TITAN 6500 problems.

Defendants Misleadingly Portrayed To The Public Tellabs' Sprint/TITAN 6500 Deal To Give A Misleading Impression Of Demand For Its TITAN 6500 Product

54. Defendants touted a $100 million deal with Sprint for the TITAN 6500 to foster a false impression that there was demand for the product. Defendants concealed that Sprint had made this deal only to fulfill a pre-existing financial obligation concerning a different product, and that further orders would *not* be forthcoming.

55. According to two former Tellabs marketing managers, CS-1 and CS-8, and a former Tellabs market strategy executive, CS-16, Sprint entered into the TITAN 6500 agreement *to satisfy an already-existing $100 million commitment*, which arose when Sprint backed out of a previous deal to purchase Tellabs' AN-2100 media gateway. In truth, Sprint was *not* planning to buy any more TITAN 6500 products from Tellabs once Sprint satisfied its pre-existing open commitment. Yet, Defendants deceptively presented the Sprint sale as an indication that there was a growing market for the TITAN 6500.

Tellabs' SALIX Technology Could Not Be Commercialized

56. Defendants glowingly portrayed Tellabs' supposed "launch" of its new "leading edge" SALIX technology in 2000 when, in fact, the SALIX technology was both unfinished and outmoded. The technology required massive infusions of cash and personnel to commercialize--which Tellabs did not provide, and was in any event outmoded technology.

57. According to a high-level SALIX/Tellabs operations executive, CS-18, there were serious technical defects with the SALIX product—and Tellabs knew from "day one" that SALIX's staff of 50 would need to be increased to at least 300 to successfully commercialize the SALIX product. However, CS-18 explained that Tellabs did not invest more money and personnel in the product (as Tellabs originally committed to do), and thus the product could not be commercialized. CS-18 explained that SALIX failed because of the downturn in the market and because the product could not be commercialized. According to CS-18, Level 3 was the only SALIX customer of significance. The same source explained that Defendant Kohler knew exactly what was being purchased by customers, because Tellabs had to buy material for the product and because Kohler attended meetings at the Level 3 customer site in Colorado and made presentations to the customer. According to CS-18, the "bottom line" was that Tellabs executives knew exactly what was going on concerning SALIX's customer. According to the same source, Tellabs executives were well aware of the customer's business potential, and had "first hand" knowledge from attending meetings at the customer's site.

58. CS-19, a former high level Tellabs sales executive, also confirmed that Level 3 was virtually the only customer for the SALIX product, and that Tellabs reversed the revenue from the one or two deals it had for the SALIX product (which were with Level 3) when Tellabs discontinued the SALIX business.

59. CS-16 reported that the SALIX technology was not suitable for the market.

60. In a "town hall" meeting in or about late April 2001 at Tellabs' Lisle office attended by roughly 50 to 100 employees, Notebaert conceded that the SALIX technology was not current technology, and that there were other technologies that superceded it, according to CS-9, a former Tellabs

project manager. CS-6 confirmed that Notebaert made the decision to kill the SALIX product.

61. Moreover, CS-6 explained that the SALIX product required "second party software" that Tellabs did not own and that the software supplier was purchased by a competitor, causing problems for Tellabs.

Defendants Engaged In Undisclosed Illegitimate Sales and Channel Stuffing Practices To Falsely Portray Product Demand

62. To falsely portray substantial and growing revenues and demand, Defendants knowingly engaged in undisclosed extraordinary and illegitimate sales practices and "channel stuffing" of Tellabs' primary product, the TITAN 5500. As Defendants knew would occur, this resulted in drastically reduced sales and huge customer returns of unwanted merchandise in early 2001 and thereafter. Other illicit (and undisclosed) sales practices used by Defendants to create a false picture of robust demand included writing orders for customers for products that the customers did not want, and back-dating sales. Defendants also gave customers significant "incentives" to take merchandise, which belied Defendants' false portrayals of strong demand for Tellabs' products. Such incentives, which were concealed from the investing public, were excessive, unusual, and departed from ordinary business practices. Defendants' reliance on such deceptive devices to foster an illusion of demand provide further confirmation that demand for Tellabs' products was, in fact, declining and operated to deceive the investing public concerning the true state of Tellabs' business.

63. According to CS-3, a high-level Tellabs sales executive, Tellabs employees actually wrote purchase orders for customers for products that the customers had not ordered. Moreover, according to CS-3, Tellabs' Verizon team used channel stuffing as a strategy.

64. Tellabs' channel stuffing of the TITAN 5500 product in late December 2000 was of an "extraordinary" magnitude, according to CS-6, a former Tellabs senior business manager.

65. CS-21, a former Tellabs sales director, noted that sales of the TITAN 5500 reached a peak in 2000 (when Tellabs shipped off premises absolutely everything it could get out although nobody needed the product), then noticeably declined in early 2001, and continued to plummet through 2001.

66. A former Tellabs marketing manager, CS-8, also stated that Tellabs definitely channel-stuffed and loaded up distributors "big and fat" at the end of the fourth quarter 2000 (especially in December). According to CS-8, distributors were upset and later returned the inventory.

67. CS-6, a Tellabs senior business manager, explained that Telcobuy.com (a VARS that distributed to SBC) and Verizon were two of Tellabs' customers victimized by channel stuffing. Channel stuffing in December 2000 involving SBC alone amounted to roughly $20 million in revenue. According to CS-6, Tellabs paid VARS, including Telcobuy.com, a certain percentage, 5% or 10%, to hold inventory, an abnormal practice in the industry. Telcobuy wanted to return the product because it realized that it could not sell the product to SBC and that Tellabs had jammed Telcobuy. A lot of the inventory, approximately $10 to $15 million, came back in 2001. CS-6 also reported that Tellabs' executives approved this channel stuffing; that Defendant Notebaert worked directly with Tellabs' sales personnel to channel stuff SBC; and that Tellabs' chief financial officer, Defendant Ryan, also knew about the channel stuffing.

68. Similarly, a former Tellabs customer service accounts representative, CS-10, stated that Tellabs sent customers product (especially the TITAN 5500) that the customers (including Lexcom, Verizons, and Telcobuy) did not want. According to CS-10, the customers returned the TITAN 5500

merchandise as soon as it showed up at their door. CS-10 also reported that often the customer's site was not ready for product; yet Tellabs delivered the product anyway to make its revenue numbers. This customer service representative (CS-10) also reported processing millions of dollars of returns from customers of unwanted product, mostly the TITAN 5500. CS-10 also stated that returns were so heavy during January and February 2001 that Tellabs had to lease extra storage space to accommodate all the returns; returns in January, February, and March 2001 were in the millions of dollars. Verizon and Telcobuy were heavily returning product, according to CS-10.

69. According to another former Tellabs marketing manager, CS-1, Tellabs got "creative" to make the numbers at the end of the fourth quarter of 2000 and early 2001, including offering customers discounts of as much as 10% to 20% and other incentives (which were not disclosed to the investing public), shipping to distributors (including shipping the TITAN 5500 to distributor Lexcom in early 2001) without having agreement by the ultimate customer to purchase the product, as is customary in the industry, which resulted in returns the subsequent quarter.

70. In addition, according to CS-1, Defendants also engaged in improper practices to meet earnings expectations, such as backdating sales for the TITAN 5500—pulling sales to larger customers such as SBC and Sprint from the first quarter 2001 into the fourth quarter of 2000 to make the numbers.

71. According to CS-3, a high-level Tellabs sales executive, Verizon unsuccessfully tried to return a lot of product. Verizon's Chairman Charles Lee even called Tellabs to complain about channel stuffing. As CS-3 also maintains, Tellabs distributors Telcobuy.com and Lexcom were also victimized by Tellabs' channel stuffing. According to CS-3, Telcobuy.com tried to return product to Tellabs during late

1999 through late 2000. Tellabs offered Telcobuy very generous credit terms (90 days net)—much more than normal (30 days net)—to induce Telcobuy to keep the products. Tellabs also gave Telcobuy additional discount incentives to buy TITAN 5500 plugs in late 1999 through late 2000.

72. CS-5, who was involved in Tellabs distribution, confirmed that Tellabs sent customers an extraordinarily tremendous amount of product during the last 6 weeks of the fourth quarter of 2000, requiring Tellabs distribution employees to work 16 hours a day, seven days a week, and the Company still needed more distribution help. CS-4, a Tellabs shipping supervisor, also confirmed that at the end of each quarter, particularly the fourth quarter of 2000, Tellabs distribution personnel worked double shifts to push out product, from 6:00 a.m. until 12:00 midnight. But as soon as the first quarter of 2001 hit, Tellabs did not have orders, there was no more work, and Tellabs distribution employees were told to go home early, according to CS-5.

DEFENDANTS' MATERIALLY FALSE AND MISLEADING STATEMENTS DURING THE CLASS PERIOD

73. On December 11, 2000, the first day of the Class Period, Defendants issued a press release announcing a multi-year sales agreement with Sprint for the TITAN 6500. The press release stated:

> Tellabs today announced a multiyear agreement with Sprint for the TITAN 6500 multiservice transport switch, which will help the carrier manage exponential growth of broadband traffic while lowering its costs. The agreement is expected to be valued at more than $100 million over the life of the contract.
>
> * * *
>
> *The TITAN 6500 system is available now.* [Emphasis added.]

74. Defendants' representations regarding the TITAN 6500 and the Sprint deal in the press release quoted in the previous paragraph were materially false and misleading in that:

a. in truth, the TITAN 6500 was not then currently available;

b. production of the TITAN 6500 was far behind schedule and the product was not ready for release;

c. the TITAN 6500 was failing customer lab evaluations;

d. the TITAN 6500 was inferior to comparable products offered by Tellabs' competitors; and

e. Sprint's purchase of the TITAN 6500 was merely to satisfy a pre-existing purchase obligation that arose when Sprint canceled another product purchase, and would not result in continued sales.

75. Also, on December 11, 2000, Defendants held a conference with analysts in New York City.

76. Robert W. Baird & Co., Inc. ("Baird") issued a summary of Defendants' December 11, 2000 analysts' conference in a December 12, 2000 "Research Note," which reported the following:

* The most significant announcements of the conference were the availability of [Tellabs'] TITAN 6700 optical switch, its first purchase order for the TITAN 6100, and the announcement of a multi-year $100+ million contract with Sprint for the TITAN 6500. They expect this revenue to be accrued linearly over the next four years.

* Tellabs also reiterated its confidence in the telecom-spending environment and reconfirmed consensus growth forecasts for Q4 [2000] and 2001.

* New CEO Richard Notebaert presented first during the conference and outlined the tremendous opportunity for Tellabs in international markets, as well as the expected continuing growth of the TITAN 5500, as well as its new optical-networking and next-generation switching initiatives.
* Tellabs believes that these new optical-networking platforms expand its addressable market by nearly sevenfold to $20+ billion by 2003.
* Tellabs also outlined its outlook for its Salix next-generation soft-switching platforms where the addressed market is expected to grow to over $1 billion by 2003 and accelerate to $24 billion in 2008.
* Tellabs also reiterated its growth forecast of 30% in revenue and EPS for 2001.
* Consequently, as a result of these new and developing product initiatives and Tellabs expanding addressable markets, we expect Tellabs to maintain an above-average growth rate for at least the next 2 to 3 years.

Baird thereupon reiterated its "strong buy" rating on the Company's stock.

77. Other securities analysts following Tellabs common stock also reported on Defendants' positive representations at the December 11, 2000 conference:

a. UBS Warburg issued a report describing Defendants' fourth quarter 2000 projections:

> Tellabs maintained its guidance for 4Q of 2000 and all of 2001. In doing so, the company indicated that demand for its TITAN 5500 product line remains solid in 4Q and there is visibility for at least two years (if not more) of ongoing good growth for this product.

Estimating sales growth of about 30% in 2001, UBS reiterated its "buy" rating on the Company's stock.

b. A Morgan Stanley report focused on the new line of products announced by Tellabs and Defendant Notebaert's assertion that there was "strong demand for Tellabs' products despite capital expenditure fears by the carriers." Morgan Stanley forecasted that new product sales would contribute about $30 million of revenue in 2000 and at least $100 million in 2001, raised its price targets to $75, and maintained its "outperform" rating on the Company's stock.

c. Merrill Lynch's report on Tellabs' December 11, 2000 analyst meeting characterized the meeting as "upbeat," and stated that Tellabs "Management reiterated its forecast for 30% top and bottom line growth for 2001" and that Tellabs' "cash engine, the TITAN 5500, is still humming away." The Merrill Lynch report also stated: "[T]he strength of the TITAN 5500 gives us reasonable visibility into the near term outlook, even despite some of the industry concerns on capital spending."

d. ABN AMRO, Inc. ("ABN") reported Defendant Pullen's comment that the "*TITAN 5500 remains the workhorse of the group and is expected to see strong growth for the next 2-3 years.*" (Emphasis added.) Relying on Defendants' statements, ABN raised its price target and earnings per share and reiterating its "buy" rating on the Company's stock.

e. Robinson-Humphrey's report on Defendants' December 11, 2000 conference stated:

> Tellabs' softswitch has also taken a jump start, with six trials currently underway at a handful of customers. *Management indicated that the trials are progressing well, especially at one large customer. . . .*

(Emphasis added.) Robinson-Humphrey also reiterated its "buy" rating on Tellabs stock based on the Defendants' assurances regarding the TITAN 5500 and the SALIX product lines.

78. On January 22, 2001, the day before Tellabs was to announce its fourth quarter 2000 earnings results, citing its high degree of confidence in the demand for Tellabs' existing and emerging products, and reflecting Defendants' guidance, Lehman Brothers issued a favorable research report forecasting 2001 revenues of $4.368 billion, an increase of 30%, and earnings per share of $2.25, an increase of 32%.

79. These and other positive analysts' reports issued during the Class Period confirm that the market was, in fact, misled by Defendants' false and misleading representations and that those representations were material.

80. Defendants' positive representations at the December 11, 2000 analyst conference, as reported by conference attendees, as set forth above, were each materially false and misleading for the reasons set forth in paragraph 74 above and for the following additional reasons, among others:

a. in truth, Tellabs was experiencing a substantial decline in the demand for its TITAN 5500 products;

b. in an effort to conceal the declining demand for the TITAN 5500, Defendants were engaging in illegitimate sales practices and a "channel stuffing" scheme, whereby the Company was:

(1) over-supplying customers with unwanted products by "stuffing" distribution channels;

(2) writing orders for products the customers did not want;

(3) improperly backdating orders; and

(4) capturing revenue from subsequent quarters by offering unusual and extraordinary discounts and incentives to customers to entice them into purchasing products during fourth-quarter 2000;

c. These deceptive sales and "channel stuffing" practices, which were designed to foster a false illusion of demand, resulted in Tellabs' customers being over-inventoried with TITAN 5500 products and caused them to decrease orders for those products in the future;

d. because of an already contracting market for telecommunications products, customers were reducing and would continue to reduce their orders for Tellabs products, including the TITAN 5500, throughout 2001;

e. the SALIX technology could not be commercialized and was already outdated and superceded; and

f. in light of the foregoing, Defendants' forecasts of revenue and earnings growth lacked any reasonable basis and were contradicted by adverse facts known to Defendants.

81. On January 23, 2001, Defendants issued a press release announcing Tellabs' financial results for the fourth quarter of 2000:

> *Strength in Tellabs' core business drove record sales and earnings in the fourth quarter of 2000.* Fourth-quarter 2000 sales totaled $1,018 million, up 42% from $716 million in 1999. . . .
>
> Fourth-quarter net income was $232 million, up 41% from $165 million a year ago, and diluted earnings per share rose to 56 cents, up 44% from 39 cents a year ago, before one-time items. Including one-time items, fourth-quarter net income was $238 million and diluted earnings per share were 57 cents.
>
> * * *
>
> *"To keep up with robust growth in communications traffic, customers are buying more and more Tellabs equipment-fueling our records results and our first $1 billion quarter,"* said Richard C. Notebaert, Tellabs chief executive officer and president. *"Customers are*

embracing the five new products we launched last year, opening new opportunities for Tellabs to grow."

(Emphasis added.) With respect to the Company's optical networking division, the press release stated in pertinent part as follows:

> Optical Networking—For the fourth quarter of 2000, sales of optical networking products [including the TITAN 5500] amounted to $641 million, up 49% over a year ago. In 2000, the Tellabs optical networking group shipped more than 14 million DS1-equivalent ports.
>
> During the quarter, Tellabs' shipped its first TITAN 6100 and TITAN 6500 systems for customer deployment. *In December, Tellabs announced that it would supply the TITAN 6500 system to Sprint under the terms of a $100 million multiyear agreement.*

(Emphasis added.)

82. On the same day, January 23, 2001, Defendants, including Notebaert, Ryan, and Jackman, held a conference call with analysts to discuss Tellabs' fourth quarter 2000 results. Notebaert stated:

> *This was a great quarter and fitting end to a wonderful year. Tellabs not only achieved record sales and profits in the fourth quarter [of 2000], we also set the stage for sustained growth with the successful launches of several products, many of those long anticipated.* First let me hit some of the highlights from our fourth quarter. *For the first time ever, we had sales of over $1 billion. I mean it's just fantastic.* All of us at Tellabs are still buzzing about that. It's a great accomplishment for us. *Customers are embracing our products. We announced a $100 million plus agreement with Sprint for the 6500. Our first customer success with this new product.* We shipped our first TITAN 6500 and our first TITAN 6100 in the forth [sic] quarter. [Emphasis added.]

83. During the same conference call, Defendant Joan Ryan stated:

> *Now, heading into 2001, we have constructed our forecast by balancing overall economic conditions against direct input from our customers about the products we sell. All indications are that Tellabs will continue to sustain our strong record of growth.* [Emphasis added.]

84. During the same call, in response to questions seeking updates on the TITAN 6500, Defendant Notebaert also stated:

> *On the 6500 demand for that product is exceeding our expectations* and I'm just gonna say a word and pass it to Brian. We had spent and we'll meet again tonight, a large amount of time working on our ability to create or manufacture enough product to meet customer demand. *Demand is just, is huge for this product.* [Emphasis added.]

Notebaert further asserted that "[i]t's not all tied to Sprint although Sprint is obviously the earliest and most visible customer."

85. In addition, on the same day, in an interview with Eric Schatzker from the Bloomberg News, on the *Bloomberg Forum*, Defendant Notebaert falsely asserted that Telltabs was not being seriously affected by the slowing telecommunications economy:

Schatzker: Okay, let's talk about your fourth quarter earnings. Came in line with expectations, earnings of 56 cents a share, and I think the big story here, really, is that's that a bit of a relief to a lot of investors who'd expected, who were fearful that the numbers might miss forecast given all the concerns about a slowdown in telecommunications spending, and I guess they'd also have to be encouraged by a reiteration or a

confirmation of your outlook for 2001, which includes growth and earnings per share, and revenue of more than 30%. Why is it that you guys seem to be holding up so well, when some of the other companies that hope to take your business away, are faltering?

Notebaert: Well, I think it goes back to our customers. I mean, everything starts with your customer. *What Tellabs has is a targeted product set that meets a customer need.* And the customer's business is growing in units, in traffic, and so our product helps them be more efficient, helps them in its scalability, and it really provides them a path to future converged networks. *And that's recognized by the customer, and they showed that again this quarter, and I'm a little surprised at the performance of our stock the last few weeks, because last quarter, this quarter, we've been solid, and we feel very, very good about the robust growth we're experiencing.* [Emphasis added.]

* * *

Schatzker: Sure. Actually, that leads me to another question, which is, we've heard over the last couple of weeks some companies in the same business you're in, or at least a similar business, companies like ABC Telecom, Nortel even, talk about how the slowing US economy was affecting their outlook and prompting them to pare back their 2001 forecast. How come that isn't really affecting you guys?

Notebaert: You know, the folks at Nortel, John Rothman and his team, have never invited me into their boardroom. So it would be inappropriate for me to comment about them, or about ABC.

Schatzker: Okay, fair enough, we can change it then, why don't you think you guys are, your company is feeling a pinch at all because of any slowdown that we might be seeing, or perceiving in the US economy?

Notebaert: I think it goes back to where I started. When you've got a product set that really creates efficiency, scalability, it leads the way to tomorrow's converged networks, but what you end up with is sustained growth. What would really—the only thing that would really change, really adversely affect a company like Tellabs, with its outstanding set, is if in fact the utilization of the network, of the Internet, in other words, people stop communicating either computer to computer with data, or by a voice . . .

86. Defendants' January 23, 2001 representations, as set forth in the foregoing paragraphs, were each materially false and misleading for the reasons set forth in ¶¶ 74 and 80 above, and for the following additional reasons, among others:

a. Tellabs' reported financial results for the fourth quarter and full year-2000 were the result of deceptive sales practices, including false and backdated orders and channel stuffing, and could not be sustained;

b. a market research study performed by Defendants and an outside research firm was accurately forecasting a significant additional drop in TITAN 5500 sales;

c. Tellabs was experiencing massive product returns; and

d. contrary to Defendants' claims, direct input from Tellabs' customers indicated that Tellabs could not sustain strong growth.

87. Following these positive announcements, securities analysts following Tellabs again issued highly positive reports based on Defendants' guidance and representations. For example:

a. On January 23, 2001, Merrill Lynch reiterated its "long term buy" rating.

b. That same day, Robinson-Humphrey also reiterated its "buy" rating, noting that "management had upheld year-end guidance for 2001, relieving many investors apprehensions."

c. On January 24, 2001, Morgan Stanley issued a report reiterating its "outperform" rating and establishing a new price target of $90 (up from its previous price target of $75) for Tellabs' shares. Noting that the Optical Networking group sales grew 49% to $641 million, up from the $429 million in fourth-quarter 1999, and that "*sales of the TITAN products continued to fuel growth*" (emphasis added), Morgan Stanley adjusted its 2001 revenue estimate to $4.4 billion, up from its previous $4.3 billion estimate and revenue growth greater than 30%.

d. Deutsche Banc also issued a report on January 24, 2001, raising its 2001 estimates from $4.21 billion to $4.37 billion and maintaining its "buy" recommendation on Tellabs stock.

88. The following week, on January 30, 2001, Defendants issued another press release, announcing "a new suite of softswitches, the SALIX 7600 softswitch control suite, which helps carriers increase revenue by building low-cost networks that deliver innovative new services quickly." The press release states:

> "Tellabs is committed to delivering new next-generation switching solutions that will prepare the world's communications networks for tomorrow," said Brian Jackman, president of Global Systems and Technology at

Tellabs. "The SALIX 7600 suite brings together voice and data technologies to create a set of telepacket service applications that can help carriers grow profitably."

The SALIX 7600 suite is the latest addition to the award-winning SALIX 7000 series of products, which includes the SALIX 7700 gateway service switches and the SALIX 7400 integrated management suite. With the new SALIX 7600 suite, Tellabs has redefined the soft-switch market and *can now offer* integrated, comprehensive solutions to all carriers. [Emphasis added.]

89. Defendants' positive representations concerning the SALIX 7600 suite were materially false and misleading in that, among other things, the SALIX technology could not be commercialized and already was outdated and superceded.

90. On February 14, 2001, Defendants issued Tellabs' year 2000 Annual Report. The letter to stockholders contained therein, which was signed by Defendants Notebaert and Birck, stated:

Dear Fellow Stockholders:

Tellabs' growth is robust. In 2000 we exceeded our targets of 30% growth in sales and earnings for the fifth consecutive year. *Sales rose 46% to $3.4 billion.* Earnings per share increased 33% to $1.75. *Our results set new records* across the board, as you can see on the facing page.

* * *

Our markets and products hold significant potential for sustained growth.

Communications traffic is growing—that's no surprise. But you may be surprised to hear that most telephone calls and Internet sessions in the United States now flow through Tellabs equipment. That's how ubiquitous our products have become, because we bring customers

exactly the solutions they need. Looking through the eyes of our customers, Tellabs is ideally positioned in three high-growth markets—optical networking, broadband access and next-generation switching. Industry analysts forecast that these markets will grow sevenfold by 2003.

* * *

Our core business is performing well, which reflects customers' needs to handle traffic growth, add new services and migrate to future technologies without stranding assets. For example, *sales of our TITAN 5500 digital cross-connect systems soared 56% in 2000, our third consecutive year of accelerating growth.*

* * *

The new TITAN 6500 multiservice transport switch emerged from our laboratories in 2000, and customers are embracing it. Sprint, for example, announced a multiyear agreement for more than $100 million. And we're just getting started.

In all, we *launched* five major new products last year—the TITAN 6100 optical transport system, the FOCUS 6200 dense wavelength division multiplexer, the *TITAN 6500 multiservice transport switch*, the VERITY 3000 voice-quality enhancement series and the *SALIX 7750 next-generation switch*. All around Tellabs, you hear employees buzzing with excitement as they talk to customers about the potential of these products and how they will lead the way to tomorrow's converged networks.

* * *

Tellabs' best is yet to come.

(Emphasis added.)

91. Defendants Birck and Notebaert answered investors' frequently asked questions in the Annual Report, including the following:

> Q. *Your core business is built on the TITAN 5500—are you worried that this product has peaked?*
> A. *No. In 2000, TITAN 5500 revenues grew 56%, its best year so far.* Although we introduced this product nearly 10 years ago, *it's still going strong* because we keep adding new capabilities so it can do more and more for our customers. For example, last year we introduced a new TITAN 5500 system with 50% more capacity—enough to handle 1 million simultaneous Internet sessions. Now customers want an even larger TITAN 5500 system. That's why we believe there are many years of life ahead for this highly successful product.
> Q. How are you doing with introducing new products?
> A. . . . *The new SALIX 7750 next-generation switch positions Tellabs in a new category where we see a lot of opportunities. . . .*

(Emphasis added.)

92. Tellabs' 2000 Annual Report also contained a list of "reasons to invest in Tellabs," including:

> *High growth markets*—As demand for communications expands, the telecom equipment market is growing 20% to 25% as year. Tellabs is focused on attacking three market segments that offer major growth potential—and *we're delivering the right products* to meet customer needs in these market segments.
>
> Optical networking: Analysts foresee the pure optical segment soaring from $810 million in 2000 to $6 billion in 2003, as communications companies carry more and more traffic through fiber optic networks. To tap this growth, we offer a range of end-to-end solutions in our

TITAN and FOCUS series that can handle everything from a single voice circuit to a wavelength of light.

Next-generation switching: Analysts forecast growth from $76 million in 2000 to $1.2 billion in 2003. Next-generation switches offer communications companies a way to add new services quickly and incorporate new levels of efficiency into communications networks. *Our new SALIX next-generation switches have built an enviable track record in this fledgling market.*

(Emphasis added.)

93. Tellabs' 2000 Annual Report also discussed Tellabs' strategies:

We're building on our robust core business.

We see strong growth in our core business as we help customers meet increasing demand for bandwidth. Our core business is the foundation of our strong relationships with major customers, who rely on Tellabs to help them migrate to the networks of the future.

* * *

We successfully launched five new products in 2000.

For 26 years, Tellabs has focused on changing leading-edge technology into solutions that are viable for our customers. Our aim is to be a focused attacker that brings best-in-class products to market. We're furthering that aim with five *major new products we began selling last year*—the TITAN 6100 optical transport system, the *TITAN 6500 multiservice transport switch*, the FOCUS 6200 dense wavelength division multiplexer, *the SALIX 7750 next-generation switch* and the VERITY 3000 voice-quality enhancement series—which complement our core products.

(Emphasis added.)

94. In addition, Tellabs' 2000 Annual Report contained a "Management Statement of Financial Responsibility" signed by Defendants Birck, Notebaert and Ryan, that declared:

> *The financial statements of Tellabs, Inc., and Subsidiaries have been prepared under the direction of management in conformity with generally accepted accounting principles.* In the opinion of management, the financial statements set forth a fair presentation of the consolidated financial condition of Tellabs, Inc., and Subsidiaries at December 29, 2000, and December 31, 1999, and the consolidated results of its operations for the years ended December 29, 2000, December 31, 1999, and January 1, 1999.
>
> The Company maintains accounting systems and related internal controls which, in the opinion of management, provide reasonable assurances that transactions are executed in accordance with management's authorization, that financial statements are prepared in accordance with generally accepted accounting principles, and that assets are properly accounted for and safeguarded.

95. Defendants' positive representations in the 2000 Annual Report, as set forth in the preceding paragraphs, were each materially false and misleading for the reasons set forth in ¶¶ 74, 80 and 86 above. In addition, the assertion in "Management Statement of Financial Responsibility," which was signed by Defendants Birck, Notebaert, and Ryan, that Tellabs' financials were fairly presented and conformed with GAAP was materially false and misleading in that the Company's financials were not fairly presented and did not conform with GAAP. Among other things, Defendants wrote fictitious orders and recorded revenues for sales customers never agreed to.

96. Defendants' positive announcements in December 2000 and January and mid-February 2001 had their desired

effect—the price of Tellabs common stock rose from a low of $58.4375 per share on December 11, 2000 to a Class Period high of $67.125 per share on February 5, 2001. It was during this period that three Individual Defendants sold personally-owned Tellabs common stock for proceeds of over $5.75 million:

a. On February 2, 2001, Defendant Kohler sold 7,500 shares of Tellabs stock at $64.66 per share, receiving proceeds of $484,000;

b. Between February 1, 2001 and February 6, 2001, Defendant Birck sold 80,000 shares of Tellabs common stock at prices ranging from $64.25 to $65.38 per share, receiving proceeds of $5,180,000; and

c. On February 15, 2001, Defendant Kozik sold 3,220 shares of Tellabs common stock for proceeds of $187,000.

97. Based upon the financial information and positive statements reported by Defendants, analysts maintained their buy recommendations for Tellabs stock. On February 21, 2001, Lehman Brothers analyst S.D. Levy, in response to disappointing results reported by Tellabs' competitor Nortel, explained why Lehman Brothers remained comfortable reiterating its "strong buy" rating on Tellabs:

> Halfway into the first quarter, Tellabs' revenues visibility remains as strong as when it ended the year with record order backlog. *We have spoken with multiple members of the management team in the past few days and each one said that after scrubbing the forecasts yet again, there was no change to its near- or long-term outlook.*

(Emphasis added.)

98. Similarly, one week later, on February 28, 2001, in response to a decline in stock price due to industry trends,

Lehman Brothers issued a favorable report on Tellabs, again reiterating its "strong buy" rating:

> The bottom line then is that we do not believe the fundamental situation for Tellabs has changed and not do we believe is it likely to get any worse because of the functionality of its products. New customer announcements should get the stock moving in the right direction and negative sentiment is unwarranted.
>
> Tellabs remains our number one investment idea.

99. Less than two weeks later, on March 7, 2001, Defendants issued a press release slightly modifying their previous guidance for the first quarter and full year 2001 and falsely reassuring the investing public that customer acceptance and demand for the TITAN 6500 remained strong and that the Company continued to expect 30% growth. The release stated in part:

> Tellabs announced today that it is lowering its revenue and earnings per share expectations for the first quarter 2001. *Tellabs projects first quarter sales in the range of $830 million to $865 million, compared with prior guidance of $865 million to $890 million. The company projects earnings per share in the range of 35 cents to 38 cents, compared with prior guidance of 39 cents per share.*
>
> The new guidance stems from continuing below-trend growth in Tellabs' CABLESPAN® business. In addition, the company is unable to recognize revenue from shipments of its new TITAN® 6500 system in the first quarter as originally anticipated, but *expects to recognize revenue from shipments of its new TITAN® 6500 system revenues in the second quarter. Growth in Tellabs' core optical networking business remains strong.*
>
> * * *

> *"Given the strong acceptance of the new TITAN 6500, we continue to target 30 percent growth in revenue and earnings for the year,"* said Richard C. Notebaert, Tellabs president and CEO. *"Demand for our new products is strong, and I am confident we have the right set of solutions to help our customers build tomorrow's converged networks."* [Emphasis added.]

100. The next day, on March 8, 2001, Defendants, including participants Notebaert, Ryan, and Jackman, held a conference call with analysts. Defendants again reassured investors that Tellabs was not experiencing the same negative effects of the industry slow-down as its competitors, and that its core business remained strong. For example, Defendant Notebaert opened the discussion by stating:

> Let me start by saying that our business is quite healthy; in fact, most of the fundamental trends that we talked about on our January call are intact. That is, and let me be a little more detailed, *demand for our core optical products, or our core networking products remains strong. . . . Interest in and demand for the 6500 continues to grow. . . . We continue to ship the 6100 and 6500 through the first quarter. We are satisfying very strong demand and growing customer demand. We are as confident as ever—that may be an understatement—about the 6500. . . . To put this into a bit more perspective, we still expect revenue and EPS growth for the quarter to exceed 30%. . . . In summary, demand for our products remains strong and there will be optimism around the new products that we've introduced. Tellabs will meet the adjusted revenue and earnings targets. . . .*

(Emphasis added.)

101. In response to a question posed by an analyst at UBS Warburg regarding the TITAN 6500 and why revenues were not recognized, Defendant Jackman stated:

> *There's nothing in the revenue recognition issue that should be construed to imply that the testing and the customer's acceptance of these systems are having difficulty.*

(Emphasis added.)

102. Similarly, in response to a question posed by an analyst from Deutsche Bank as to whether Tellabs was experiencing "any weakness there at all" as to TITAN 5500, Defendant Notebaert stated:

> *No, we're not. We're still seeing that product continue to maintain its growth rate; it's still experiencing strong acceptance. We're in the process of installing . . . a large number of frames that we shipped in the fourth quarter and business continues to grow as usual.*

(Emphasis added.)

103. Further, when asked if the Company had any concerns related to the lowered expectations of its competitors Nortel and Cisco, Defendant Notebaert falsely asserted that the Company was not experiencing the same adverse effects as its competitors:

> *we haven't Rotten any indication, I haven't gotten any indication from any of our major clients, major customers, of a downturn in the segment we're in, .*

(Emphasis added.)

104. Defendants' positive representations and assurances in the March 7 press release and the March 8 conference call set forth above, were materially false and misleading for the reasons set forth in ¶¶ 74, 80 and 86 above.

105. As a result of Defendants' positive assurances, securities analysts following the Company issued favorable reports and maintained their buy recommendations. For example, on March 8, 2001:

a. Deutsche Banc maintained its "buy" rating on Tellabs stock, noting that TITAN 5500 sales continue to be strong.

b. UBS Warburg reported that the Company would recognize revenue from the TITAN 6500 in the second quarter and maintained its "buy" rating on Tellabs stock.

c. Robinson-Humphrey issued a report maintaining its "buy" rating, stating that it believed Tellabs' core growth drivers were strong and that the TITAN 6500 had met strong market acceptance.

d. Similarly, reiterating its "strong buy" recommendation, Baird noted that the delay in recognizing revenue from the TITAN 6500 "does not in any way reflect lack of acceptance of the new product (TITAN 6500)."

106. Defendants' strong representations regarding the TITAN 5500 and 6500 products sent Tellabs common stock up from a low of $44.625 on March 7, 2001 to a high of $49.50 or March 8, 2001.

107. On March 29, 2001, Defendants filed with the SEC Tellabs' 10-K for the fiscal year ended December 29, 2000, which was signed by, among others, Defendants Birck, Notebaert, Ryan, and Jackman. In the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations," Defendants falsely represented:

> 2000 Highlights
>
> *The Company achieved record levels in sales ($3,387.4 million), net earnings ($730.8 million) and earnings per share ($1.75) –putting it on track to meet its objective of $6 billion in annual revenues by the year 2003.*

* * *

Results of Operations 2000 vs. 1999

Sales for 2000 totaled $3,328.6 million, an increase of 43.3% over 1999 sales of $2,322.4 million. *The growth in overall sales was primarily attributable to increased sales of optical networking products.* Sales of optical networking products were $2,107.9 million in 2000, a 54.1% increase compared to $1,367.5 million in 1999. *The growth in optical networking product sales was a result of continued strong demand for the Company's TITAN 5500/5500S and TITAN 532L digital cross-connect systems.*

Tellabs views next-generation switching as a future growth area for the Company. *Leading that growth will be the Company's SALIX 7000 family of next-generation switching products. . . .*

* * *

Outlook

Tellabs expects continued strong sales growth in 2001. Sales growth within the United States will continue to be driven by optical networking product sales. . . . From a product standpoint, the Company expects that the TITAN 6500 MTS and TITAN 6100 OTS will contribute to overall sales growth in 2001. . . .

(Emphasis added.)

108. Tellabs' 2000 Form 10-K also favorably discussed its SALIX technology:

In February 2000 the Company acquired SALIX Technologies, Inc., strengthening the Company's ability to deliver next-generation converged network solutions. The SALIX 7000 family of next-generation switches features cost-effective voice to data network migration

by integrating circuit switching into ATM and IP broadband infrastructures. . . . The SALIX next-generation switches enable service providers to seamlessly move voice traffic onto data networks while supporting voice services. This family of switches places the Company in a high-growth market and new category, offering companies a way to rapidly create new services and increase efficiency in communications networks. A major product that was introduced in the year 2000 was the SALIX 7750 next-generation switch.

109. In addition Tellabs' 2000 Form 10-K discussed the "strong demand" for the TITAN 5500 and growth prospects for the SALIX:

Results of Operations 2000 vs. 1999

Sales for 2000 totaled $3,328.6 million, an increase of 43.3% over 1999 sales of $2,322.4 million. *The growth in overall sales was primarily attributable to increased sales of optical networking products* [the family of products that includes TITAN 5500 as its core product]. Sales of optical networking products were $2,107.9 million in 2000, a 54.1% increase compared to $1,367.5 million in 1999. *The growth in optical networking product sales was a result of continued strong demand for the Company's TITAN 5500/55005* and TITAN 532L digital cross-connect systems. During 2000, Tellabs added two new products to its optical networking products portfolio, the previously mentioned TITAN 6500 MTS, and the TITAN 6100 OTS. . . . Next-generation switching product sales fell to $191.4 million in 2000, a 28.4% decrease compared to $267.5 million in 1999. The decrease in next-generation switching product sales was primarily attributable to lower sales of the Company's digital echo cancellers. In spite of the overall decline in sales, Tellabs views next-generation switching as a future growth area for the Company. *Leading that*

> *growth will be the Company's SALIX 7000 family of next-generation switching products*, which be[gan] field trials in the fourth quarter of 2000 with a Bell operating company. [Emphasis added.]

110. Defendants' positive representations in the 2000 10-K concerning the purported success of the TITAN 5500 and the prospects for the SALIX and Defendants' expectations of strong growth, as set forth in the preceding paragraphs, were materially false and misleading for the reasons set forth in ¶¶ 74, 80, and 86 above.

111. In addition, the 2000 10-K was materially false and misleading in that Defendants failed to describe known trends and uncertainties that had, and that Defendants reasonably expected would have a material impact on net sales, revenues, and income from continuing operations, as required by Item 303 of SEC Regulation S-K.

112. a. Moreover, Defendants' recording of revenues related to fictitious orders and sales that customers never agreed to was materially false and misleading and violated GAAP. See FASB Statements of Concepts ("Concepts") No. 5, 83-84 (recognition of revenue should occur only where two fundamental conditions are satisfied: (i) the revenue has been earned; and (ii) the amount is collectible); SEC Staff Accounting Bulletin ("SAB") No. 101 (reiterating Concepts No. 5 and requiring a contractual sale arrangement).

b. Furthermore, the 2000 10-K contained a representation that the financial statements therein:

> present fairly, in all material respects, the consolidated financial position of Tellabs, Inc., and Subsidiaries at December 29, 2000 and December 31, 1999, the consolidated results of its operations and its cash flows for each of the three years in the period ended December 29, 2000 in conformity with accounting principles generally accepted in the United States.

Such representation was materially false and misleading for the reasons set forth in the above subparagraph.

113. On April 6, 2001, Defendants issued a press release modifying their first-quarter guidance once more, projecting first-quarter 2001 sales of $772 million compared with earlier guidance of revenues in the range of $830 million to $865 million. The press release stated in part:

> The revised guidance stems from reduced and deferred spending by major communications carriers late in the quarter. Tellabs is aggressively managing its costs and aligning its products to help carriers meet the demand for bandwidth, lower their operating costs and generate new revenue.

114. The same day, Defendants, including participants Notebaert and Ryan, held a conference call with analysts. Defendant Notebaert stated:

> *In just the last few weeks*, however, we experienced a more controlled order of flow from our larger customers than we had originally anticipated. Clearly the environment has result[ed] in near-term caution in the pace at which customers are deploying equipment. Our customers are exercising a high degree of prudence over every dollar spent. Let me balance this a bit and say that *everything we hear from the customers indicates that our in-user demand for services continues to grow*. [Emphasis added.]

115. Defendant Ryan stated:

> *As we indicated in the press release issued this morning, we see first quarter revenue of approximately $772 million, which represents a 21% year-over-year growth in overall revenue*. Full diluted earnings per share of 29 cents, which represents 12% year-over-year growth from a major product line perspective. We see revenues of

> $482 million in optical networking, which represents 22% year-over-year growth, . . . As Dick indicated, we are well positioned to manage through these challenging times. Showing 21% cap line growth in this kind of environment is a real sign of the value Tellabs brings to its customers. [Emphasis added.]

116. In response to a question about the TITAN 5500, Defendant Notebaert stated:

> We had about $83 million in TITAN 5500 business. . . . And in the last 2½ weeks or so of the quarter—the last 2 weeks of the quarter—what happened was customers called and said "look we don't want to cancel the order, we want the equipment. Could you put it into the next quarter." So we got pushed out into the next quarter, which I would tell you was surprising. . . . We don't normally have those pushed forward, especially on Titan 5500. *The good news there is the orders weren't cancelled, it was just do it after the end of the quarter.* [Emphasis added.]

117. When an analyst asked, in conjunction with the testing of the TITAN 6500, "Are we still on track to recognize that [TITAN 6500] revenue in the second quarter?" Defendant Notebaert responded: "The answer is yes." Notebaert also asserted:

> . . . the 6500 is showing strength. . . . *we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong* and I don't know what else I can say about that other than it is a very bright spot for us. Looks good. [Emphasis added.]

118. An April 6, 2001 W.R. Hambrecht analyst report issued after the conference call echoed Defendant Notebaert's false explanation:

> Management blamed the shortfall on a deferral of orders for its flagship TITAN 5500 digital cross-connect late in the quarter. *More specifically, management noted that in the last two weeks, large carrier customers pushed out $83 million in orders for the 5500 to the second quarter, which would account for essentially all of the revenue shortfall.* [Emphasis added.]

119. Defendants' positive statements made in the April 6, 2001 press release and during the subsequent conference call, as set forth in the above paragraphs, were materially false and misleading for the reasons set forth in ¶¶ 74, 80 and 86 above, and for the following additional reasons, among others:

a. the projection of first quarter revenues lacked a reasonable basis and was contradicted by adverse facts known to Defendants including a severe and continuing collapse in demand for Tellabs' products.

b. contrary to Defendants' false explanation of a temporary deferral of orders, the Company's decrease in revenues was not due to recent "near term" deferred spending by communications carriers late in the quarter. Rather, as detailed above, the decrease in sales was caused by long-term decreased demand for Tellabs' products and Defendants' aggressive and improper sales and "channel stuffing" activities during fourth quarter 2000 which Defendants knew, or recklessly disregarded, would adversely affect sales of its TITAN 5500 in the future, and by the other adverse factors described herein.

120. Based on Defendants' positive representations, analysts continued to maintain the "buy" recommendations for Tellabs. For example, on April 6, 2001:

a. Salomon Smith Barney, although lowering its full-year 2001 revenue number to $3.99 billion from $4.15 billion, reiterated its "outperform" rating.

b. Lehman Brothers reiterated its "strong buy" rating, stating;

> Nonetheless, we continue to believe that end-user demand for bandwidth is the ultimate driving factor for digital cross-connect system sales, and all signs suggest this metric continues to grow. Further, we believe TITAN 5500 system pricing is holding up well. Tellabs' new product launches continue on track for revenues in the June quarter, as the company is shipping all the TITAN 6500 systems it can manufacture, with full-volume production expected in May or June.

c. Robinson-Humphrey reiterated its "buy" rating on Tellabs stock, stating that "we expect TITAN revenue and the installed base to remain robust in coming years."

d. Wit SoundView reiterated its "buy" rating, noting that "the order book still looks strong for the company's core products."

e. Baird also reiterated its "strong buy" rating, reporting that "if the $83 million in sales (for the TITAN 5500) were not deferred to future quarters, Tellabs would have easily met the previous quarterly revised estimates" and "if demand remains strong . . . it is possible that Tellabs could recover the entire amount of the deferrals in Q2 and come close to meeting original estimates for the year."

121. Less than two weeks later, on April 18, 2001, Defendants issued a press release announcing Tellabs' financial results for the first quarter ending March 31, 2001. The Company modified revenue projections for the full year from $3.99 billion to within the range of $3.6 billion to $3.7 billion, and *announced that it was exiting the SALIX product line, just 14 months after itspurchase of SALIX for $300 million.* The press release stated in part:

> In light of reduced and deferred spending by major communications carriers, Tellabs will realign its cost structure with its current expectations for lower revenue

> growth. The company will further reduce discretionary spending, eliminate salary increases this year, institute a pay-cut for all corporate officers, align manufacturing capability with demand expectations, *and terminate the SALIX next-generation-switching product effort.*
>
> * * *
>
> "These actions are unfortunate because they affect a lot of talented people," said Tellabs President and CEO Richard C. Notebaert. "By paring back our efforts in next-generation switching, we are aligning with our customers' priorities and strengthening our initiatives in high-growth areas such as optical networking. Despite the current challenges, *I am as confident as ever in Tellabs' long-term prospects and our ability to deliver strong revenue and earnings growth in the future.*"

(Emphasis added.)

122. Defendants' representations and projections concerning the Company's prospects and 2001 revenues, as set forth in the preceding paragraph, were materially false and misleading and lacked a reasonable basis for the reasons set forth in ¶¶ 74, 80, 86 and 119 above.

123. Based on Defendants' continued, and unfounded, assurances regarding the Company's performance, analysts again maintained the "buy" recommendations for Tellabs. For example, on April 18, 2001:

a. Morgan Stanley reiterated its "outperform" rating on Tellabs, noting that the Company's sales "increased to $772 million (consistent with recently revised guidance), up 21% year over year from $640 million in 1Q00."

b. Lehman Brothers reiterated its "strong buy" rating on the Company stating:

> Looking at product specific forecasts, we are forecasting combined sales for the TITAN 6500 and 6100 system of

> $175 million in 2001 and $340 million in 2000, and continue to expect initial sales of both in the second quarter with a stronger revenues ramp for the 6500 than for the 6100. Our new estimates also project TITAN 5500 sales of $1.95 billion 2001 and $2.145 billion in 2002.

c. Robinson-Humphrey reiterated its "buy" rating, noting that "optical networking (TITAN) revenue was up 22% year-over-year to $482 million, with strong sales of Tellabs flagship TITAN 5500."

d. Baird maintained its "strong buy" rating, stating that "Tellabs forecasts for the remainder of the year includes sequential improvement in the 5500 as well as contribution from the new 6000 series."

124. On May 8, 2001, Defendants filed with the SEC Tellabs' Form 10-Q for the quarterly period ended March 30, 2001, which stated in part:

> Tellabs achieved record first quarter 2001 sales of $772.1 million, 22.3% higher than last year's restated first quarter results. This marks the 39th consecutive quarter in which sales for the current quarter surpassed prior-year levels.
>
> * * *
>
> The 12.4% growth in product sales resulted from higher optical networking product sales, which continued to be driven by sales of the Company's TITAN® 5500/5500S and TITAN 532L systems. Sales of optical networking products totaled $481.6 million compared to $393.4 million in the first quarter of 2000.

125. The positive statements in the 10-Q concerning the TITAN 5500 and the Company's performance, as set forth in the preceding paragraph, were materially false and misleading for the reasons set forth in ¶¶ 74, 80, 86 and 119 above.

126. The 10-Q also was materially false and misleading in that Defendants failed to disclose known trends and uncertainties that had, and that Defendants reasonably expected would have a material impact on net sales, revenues, and income from continuing operations, as required by Item 303 of SEC Regulation S-K.

127. Defendants' baseless reassurances were successful in that Tellabs stock rose from a low of $31.90 per share on April 9, 2001 to a high of $38.24 per share on May 10, 2001.

128. Subsequently, on May 31, 2001, Tellabs issued a press release announcing that it would be taking $262 million in restructuring charges in the second quarter of 2001. According to the press release, the charges consisted of the following:

> $93 million related to Tellabs' exit from the SALIX next-generation switching business, including a $34 million inventory write-off. The remainder stems from facility closures and related fixed assets, excess purchase commitments, as well as employee-related costs from a workforce reduction.
>
> $40 million for consolidation of other excess facilities, employee-related costs and fixed-asset charges that are designed to align Tellabs' resources with demand.
>
> $129 million in other inventory-related charges, which includes a $46 million reserve for excess purchase commitments. The bulk of the inventory-related charge is for CABLESPAN products, and relates to recently reduced demand and residential service unit inventory that will be superceded by new, upgraded units later this year. The balance covers excess raw materials inventory and excess purchase commitments for other products.

129. Then, on June 5, 2001, Defendants issued a press release announcing that Tellabs was introducing an enhanced

software package for the TITAN 6500 to facilitate international communications. The press release stated in part:

> "Tellabs is enhancing our broadband networking systems to help service providers capitalize on the global business opportunities of today and tomorrow," said Robert Pullen, senior vice president and general manager of Tellabs' Optical Networking Group. *"Our TITAN 6500 system is the industry's only carrier-class transport system that uses the most innovative cell-based switching fabric with electrical and optical capabilities for converged services."*

130. The representation concerning the TITAN 6500, as set forth in the preceding paragraph, was materially false and misleading for the reasons set forth in ¶ 74 above.

THE TRUTH EMERGES

131. After the close of trading on June 19, 2001, the last day of the Class Period, Tellabs issued a press release announcing substantially revised second quarter guidance, dramatically reducing projected revenues *from the $780 million to $820 million range to $500 million, and projected earnings per share from $.29 to breakeven (before restructuring and other charges).* Tellabs provided the following explanation:

> The dramatic changes affecting the landscape of the telecommunications marketplace have continued to impact Tellabs. Service providers are temporarily able to meet increased customer demand for bandwidth by reallocating capacity within their networks and are only buying equipment to meet the immediate needs of their customers. "While we continue to see caution from our customers in the pace of equipment deployment, our market position remains intact, and we are focused on ensuring the most profitable path through the current environment," said Tellabs President and CEO Richard

> C. Notebaert. "I remain confident that Tellabs has the right people, products and strategies to meet the needs of our customers and deliver future growth."

132. At a conference call with analysts following the news release, Defendants, including conference participants Notebaert, Ryan, and Jackman, finally admitted that Tellabs' severe revenue shortfall was due almost entirely to a massive reduction in optical networking sales (*i.e.*, the TITAN 5500 series). Ryan admitted that Tellabs expected to realize "only about $210 million in optical networking revenues" in the second quarter, and characterized this as a "material shift in revenue mix across our product group."

133. On "The Bloomberg Forum," the same day, Tellabs' Notebaert also admitted that, with regard to customers, Tellabs was seeing a decline "across the board," and that the steepest drop off in revenue related to the TITAN 5500.

134. A June 20, 2001 report by W.R. Hambrecht explained:

> Tellabs indicated no real change in demand for high-bandwidth end-user services at its carrier customers, an assertion supported by yesterday's commentary by Qwest and first quarter major carrier results in general. *This suggests a more product-specific dynamic at work, with carriers working off excess TITAN 5500 inventories and not orderingproducts so far in advance.* [Emphasis added.]

135. In response to the Company's announcement, Tellabs common stock fell from a closing price of $21.20 per share on June 19, 2001 to a closing price on June 20, 2001 of $16.04 per share—a one-day decline of more than 24% per share (a $5.16 per share loss). The decline from the Class Period high of $67.125 (on February 5, 2001) to the June 20, 2001 low of $15.87 per share was more than 75%.

136. As noted in a June 19, 2001 article titled "Tellabs Plays Mini-Nortel with Steep Shortfall" appearing in The Street.com: "While it was not a total surprise on Wall Street that Tellabs was having a bad quarter, the size of its shortfall came as a big shock. 'Mind-numbing,' as one New York hedge fund manager put it."

137. The extraordinary loss per share was the greatest percentage decline in the history of Tellabs stock. Trading volume on June 20, 2001 in reaction to Defendants' June 19, 2001 announcement was an extraordinary 35,992,300 shares —the largest volume during or since the Class Period, and five times the average daily volume during the Class Period.

138. In stark contrast to the more than 24% decline in the trading price of Tellabs shares from June 19 to June 20, the S&P 500 *rose* 1% and the NASDAQ (where Tellabs shares trade) *rose* 2% over the same one-day period. The decline in Tellabs' share price was 24 times the mere 1% negative movement in the industry during the same one-day period (based on the movement of the Dow Jones Communications Technology Group, or "DJUSCT," which Tellabs identifies as its peer group in its proxy statements). Moreover, over the one-month period following the Class Period (June 19 - July 19, 2001) Tellabs shares *fell* more than 24% ($21.20 to $16.07) while the DJUSCT peer group index *rose* 8%. Over the two-month period from May 21, 2001 to July 19, 2001, Tellabs' stock price fell more than 61% (from $41.97 to $16.07) while the DJUSCT peer group index fell only 26%.

139. The price of Tellabs stock has never recovered. By September 28, 2001, Tellabs' share price fell to just $9.88. During the more than two years since the end of the Class Period, Tellabs shares have continued to trade below $20.

140. On August 22, 2001, Tellabs announced that it was reducing its workforce by 1,000 employees (a 12% reduction), closing two facilities, and further cutting operating expenses.

141. Ultimately, Tellabs admitted that Defendants were well aware that customer demand fell by at least *early* 2001. Birck and Notebaert's letter to shareholders in Tellabs' 2001 Annual Report, dated January 22, 2002, stated:

> *Early in 2001, as our customers reduced capital spending and expressed caution about the future, Tellabs began a deep process of self-examination.* We faced difficult decisions, the most onerous being our need to match capacity and expenses with demand to preserve profitability. [Emphasis added.]
>
> Making a company smaller is painful. In April 2001 we began a series of layoffs, a process that continues through March 2002, reducing our worldwide workforce by about 27% to around 6,700 people. We closed manufacturing plants in Ireland and Texas, consolidated product development and other functions from 30 facilities into 20, and cut expenses dramatically.

142. For the second quarter ended June 29, 2001, Tellabs ultimately reported net sales attributable to products of only $407,701,000 and a net *loss* of $174,702,000 as compared to net sales attributable to products of $716,596,000 and net earnings of $157,128,000 during the second quarter of 2000—a drop of more than 43% in net sales attributable to products and more than 211% in net earnings. For the six months ended June 29, 2001, Tellabs reported net sales attributable to products of $1,075,088,000 and a net *loss* of $52,195,000 as compared to net sales attributable to products of $1,310,597,000 and net earnings of $248,478,000 for the first half of 2000—a drop of about 18% in net sales attributable to products and more than 120% in net earnings. For the full year 2001, Tellabs reported net sales of $2,199,700,000 and a net *loss* of $182,000,000 as compared to net sales of $3,387,400,000 and net earnings of $730,800,000 for 2000—a decline of more than 35% in net

sales and about 125% in net earnings. Tellabs also reported a net *loss* of $313,100,000 for 2002.

143. As described herein, during the Class Period, Defendants made or caused to be made a series of materially false or misleading statements about Tellabs' business, operations, performance, products, and prospects, as detailed herein. These material misstatements and omissions had the effect of creating in the market an unrealistically positive assessment of Tellabs and its prospects and operations, thus causing the Company's common stock to be overvalued and artificially inflated during the Class Period. Plaintiffs and other members of the Class purchased Tellabs common stock relying upon the integrity of the market price of Tellabs common stock and market information relating to Tellabs, as well as reliance presumed by a material omission, and have been damaged thereby.

INSIDER TRADING

144. Individual Defendants and other Tellabs insiders benefited personally and directly from the artificial inflation of Tellabs stock by selling a total of almost 150,000 shares of Tellabs stock from their personal holdings for proceeds of more than $8,000,000, as set forth below:

Defendant Birck made the following sales during the Class Period:

Date	Number of Shares Sold	Price Per Share	Proceed
02/01/2001	25,000	$64.25	$1,606,250.00
02/02/2001	25,000	$65.00	$1,625,000.00
02/05/2001	25,000	$65.00	$1,625,000.00
02/06/2001	5,000	$65.3775	$326,887.50
Totals	80,000		$5,183,137.50

Defendant Kohler made the following sales during the Class Period:

Date	Number of Shares Sold	Price Per Share	Proceeds	Cost of Exercising Options to Purchase	Net Profit
02/02/2001	7,500	$64.6625	$484,968.75		
Totals	7,500		$484,968.75	$18,750.00	$466,218.75

Defendant Kozik made the following sales during the Class Period:

Date	Number of Shares Sold	Price Per Share	Proceeds	Cost of Exercising Options to Purchase	Net Profit
02/15/2001	3,220	$58.3125	$187,766.25		
Totals	3,220		$187,766.25	$19,983.00	$167,783.25

J. Thomas Gruenwald, Senior Vice President and General Manager - Broadband Access Group, made the following sales during the Class Period:

Date	Number of Shares Sold	Price Per Share	Proceeds	Cost of Exercising Options to Purchase	Net Profit
01/31/2001	1,500	$62.1875	$93,281.25		
Totals	1,500		$93,281.25	$12,563.00	$80,718.25

William F. Souders, a Director, made the following sales during the Class Period:

Date	Number of Shares Sold	Price Per Share	Proceeds	Cost of Exercising Options to Purchase	Net Profit
04/20/2001	7,450	$35.01	$260,824.50		
04/20/2001	8,550	$35.00	$299,250.00		
Totals	16,000		$560,074.50	$331,500.00	$228,574.50

Peter A. Guglielmi, a Director, made the following sales during the Class Period:

Date	Number of Shares Sold	Price Per Share	Proceeds	Cost of Exercising Options to Purchase	Net Profit
05/03/2001	5,000	$39.10	$195,500.00		
05/03/2001	5,000	$39.15	$195,750.00		
05/03/2001	5,000	$39.50	$197,500.00		
05/03/2001	5,000	$39.80	$199,000.00		
05/03/2001	10,000	$39.00	$390,000.00		
05/03/2001	10,000	$39.30	$393,000.00		
Totals	40,000		$1,570,750.00	$30,628.00	$1,540,122.00

GRAND TOTALS	148,220		$8,079,978.25

145. Individual Defendants' and other insiders' sales of Tellabs shares were highly suspicious and unusual in that, among other things:

a. The amounts of the sales were massive, both in dollar terms and in terms of the numbers of shares sold;

b. The timing of the sales by different insiders was coordinated. Over one approximately two-week period during the Class Period, which coincided with the Class Period high, at least four insiders (insider Gruenwald, and Individual Defendants Birck, Kohler, and Kozik) sold a total of 92,220 shares for proceeds of $5,949,153.75. Over another two-week period, two other insiders (Souders and Guglielmi) sold a total of 56,000 shares for proceeds of $2,030,825;

c. None of the above insiders *purchased* any shares of Tellabs stock during the Class Period (other than, in certain cases, as indicated above, exercising options to purchase shares, at prices substantially below the market price, that were then immediately sold for a substantial profit);

d. During the six months before and after the Class Period, four of the six insiders referred to above did not sell any shares of Tellabs stock;

e. The insiders' sales occurred within days of Defendants' public statements complained of herein, as detailed above.

146. By reason of their sales of Tellabs stock during the Class Period, as set forth above, while in possession of non-public material adverse information concerning the Company, Defendants had a duty to make full disclosure of such information.

SCIENTER ALLEGATIONS

147. Defendants acted with scienter in that Defendants knew or recklessly disregarded that they issued or disseminated or acquiesced in the issuance or dissemination of public

documents and statements that were materially false and misleading, as set forth herein. The Individual Defendants, by virtue of their receipt of information reflecting the truth regarding Tellabs, their control over and receipt of Tellabs' materially false and misleading misstatements, and their associations with the Company which made them privy to confidential proprietary information concerning the Company, were active, culpable, and primary participants in the fraudulent scheme alleged herein. The Individual Defendants knew or recklessly disregarded the materially false and misleading nature of the information they caused to be disseminated to the investing public.

148. Defendants also knew or recklessly disregarded that the misleading statements and omissions complained of herein would adversely affect the integrity of the market for the Company's common stock and would cause the price of the Company's common stock to be artificially inflated. Defendants acted knowingly or in such a reckless manner as to constitute a fraud and deceit upon Plaintiffs and other members of the Class.

149. In addition to the foregoing and other facts alleged herein, the following facts provide compelling evidence that Defendants acted with actual knowledge, or, at the very least, with extreme recklessness.

150. Defendants had a powerful motive to inflate the price of Tellabs' stock. As detailed above, Individual Defendants, and other Tellabs insiders, benefited personally from the artificial inflation of Tellabs stock by selling a total of approximately 150,000 shares of Tellabs stock from their personal holdings for proceeds of over $8 million. As detailed above, these sales were highly suspicious and unusual, and were timed to take maximum advantage of Defendants' false and misleading statements about Tellabs' business, performance, products, and prospects.

151. Defendants had the opportunity to commit the fraud alleged. As the top officers and directors of Tellabs, the Individual Defendants controlled the dissemination of, and could thereby falsify, information about Tellabs' business, performance, products, and prospects that reached the investing public and affected the price of Tellabs stock. The Individual Defendants controlled the content of Tellabs' press releases, corporate reports, SEC filings, and other public statements, which were created, reviewed, and approved by them.

152. The Individual Defendants were senior executive officers and directors of Tellabs and were intimately involved with and had direct responsibility with respect to important issues affecting the Company's business, operations, products, performance, and prospects.

153. Defendants were kept informed on an ongoing basis by a variety of means, including reports, meetings, and participation in discussions with respect to the serious problems affecting the Company's business, products, performance, and prospects. For example:

a. According to Confidential Sources, including CS-9, CS-15, and CS-24, top Tellabs executives, including Defendants Birck and Notebaert, conducted or were otherwise present at monthly "town hall" meetings of Company employees during the Class Period to discuss the Company's business and performance, including a meeting in or about late April 2001 at Tellabs' Lisle office attended by approximately 50 to 100 employees at which, among other things, Notebaert commented that the SALIX technology was not current and was superceded by other technologies. According to CS-15, Defendant Ryan made quarterly presentations with respect to Tellabs' financial position at the "town hall" meetings.

b. Tellabs' executives gathered and reviewed Tellabs' business at monthly and quarterly meetings at Tellabs' Illinois headquarters, according to CS-19. At those meetings, the executives reviewed all aspects of the business, including finance, operations, and sales. CS-20 also confirmed that Tellabs' executives had frequent meetings to address the Company's tactical and strategic issues.

c. In early February 2001, Defendant Notebaert attended a meeting with approximately 24 SALIX and Tellabs employees regarding the SALIX product line, according to CS-7.

d. Tellabs' finance department prepared quarterly status reports concerning the profitability of Tellabs' products, according to CS-17. People who had access to the Tellabs' database system—SAP Business Warehouse—could obtain copies of the reports, according to CS-17. CS-17 also revealed that these reports showed a decline in customer demand for the TITAN 5500 by March 2001.

e. As related by CS-20, Tellabs executives had computer access to *daily* reports concerning Tellabs' daily product bookings and revenue, through Tellabs' financial system. According to CS-20, Defendant Kohler, looked at these reports, and Defendant Jackman also reviewed these reports on approximately a weekly basis.

f. According to CS-7, Tellabs management viewed weekly and monthly reports concerning a variety of issues, *including the status of product development.* As CS-7, a former Tellabs sales director, further related, Tellabs' sales personnel wrote up weekly sales projection reports, weekly reports on field trials, and customer maintenance reports, which updated trial status.

g. According to CS-21, a sales director, Defendant Notebaert and other Tellabs' executives had telephone calls every day and stayed on top of everything. In addition,

according to CS-21, the top executives had weekly revenue calls, after which the Senior Vice Presidents would have a discussion with Defendant Notebaert. The same source explained that the revenue calls happened early in the morning, lasted about an hour, and primarily concerned how Tellabs would "make its numbers."

154. According to CS-15, a Tellabs business development manager, Notebaert and Birck and other Tellabs executives had direct knowledge of Tellabs' business activities and customer relationships. According to CS-15, Notebaert and Birck had their "hands on the pulse of everything" that happened at Tellabs. They worked very closely with the sales teams and other personnel. They spent a great deal of time of the telephone and in lots of meetings with Tellabs' sales teams. Birck and Notebaert knew the status of each product, how it was working, if the product was selling, and to whom from speaking with sales people; from "town hall" meetings at 7:30 and 9:30 in the morning at which the entire Company heard presentations as to what was going on with different products; and from briefings from sales people as to what the customers wanted and were buying.

155. CS-24 noted that Tellabs' executives and directors were "hands on" and knew everything, including the product development cycles, everyday happenings of the Company, and customer expectations.

156. CS-6, a former Tellabs senior business manager, reported that Tellabs' executives approved the TITAN 5500 / SBC channel stuffing; that Defendant Notebaert worked directly with Tellabs' sales personnel on SBC channel stuffing; that Tellabs' chief financial officer, Defendant Ryan, also knew about the channel stuffing; and that Notebaert reviewed the SALIX product line and obtained data from different sources within the Company as to the progress of the SALIX product, and made the decision to kill the SALIX product. High-level former Tellabs sales executive CS-3 also

confirmed that senior management, including Notebaert, unquestionably knew about the channel stuffing activity relating to the TITAN 5500, and that senior management, including Notebaert, pushed and prodded the Company's sales personnel.

157. As CS-16 reported, prior to Notebaert's appointment as Tellabs' CEO, Jackman and Birck ran the Company, and all information flowed up to them. As the head of Tellabs' "Product House," it was Jackman's responsibility to know what the market was doing so that he could invest in the right products to meet the market. According to CS-24, Defendant Ryan had direct knowledge of Tellabs' financial activities.

158. According to CS-19, a high-level Tellabs sales executive, Kohler was a sales-oriented person, and Jackman ran the whole product side of Tellabs' business. Jackman reported directly to Birck.

159. In addition, according to CS-1, senior management, including Defendant Robert Pullen, was aware of the TITAN 6500 production problems and that the product was failing evaluations. Moreover, as CS-1 reported, Pullen made numerous visits to TITAN 6500 customers regarding such failed evaluation problems.

160. The products at issue in this action, especially the TITAN 5500, were critical to the Company's overall performance and prospects during the relevant time. For example, the Company's 2000 10-K described the TITAN 5500 as the Company's "flagship" product, and the 2000 Annual Report identified the TITAN 5500 systems as the Company's "core products."

161. The customers at issue in this action, including Verizon and SBC, were critical to the Company's business. For example, in 2000, sales to Verizon, Tellabs' largest customer, accounted for more than 19% of consolidated net sales. No other customer accounted for more than 10% of

consolidated net sales that year. The importance of Tellabs' relationships with such key customers as Verizon and SBC compels a strong inference that, as the top executive officers and directors of Tellabs, Defendants knew about significant problems and other matters affecting those relationships.

162. The transactions that are described herein were in dollar terms large and were highly important to the Company's performance and prospects.

163. The problems affecting the Company's products and performance were of such a nature and severity, as specified above, as to compel an inference of knowledge on the part of Defendants.

164. During the Class Period, Defendants had direct communications with Tellabs' customers. For example, according to CS-15, Defendant Kohler was one of the Tellabs executives who frequently attended quarterly meetings with senior level people at Verizon, AT&T, and other Tellabs' customers. As a result of such meetings, CS 15 reported, Tellabs management knew how much the customer was buying, how much the customer planned to buy, and whether the customer was going to cut pricing.

165. CS-18, a former high-level SALIX / Tellabs executive, reported that Kohler knew of the problems with the SALIX and visited SALIX customer Level 3 at Level 3's Colorado site. CS-18 also reported that Kohler was knowledgeable concerning the progress of the SALIX because Kohler had to purchase materials for the product.

166. CS-11, a Tellabs regional sales director, confirmed that Notebaert had knowledge of the sales problems.

167. CS-16, a former Tellabs marketing strategy executive, reported that Tellabs did extensive market research, and had a budget for market research of approximately $400,000 to $500,000 per annum through the beginning of the Class

Period. This included $100,000 paid to an independent research firm for the data on T1 circuits in early 2001 that indicated that Tellabs' TITAN 5500 revenues were about to significantly decline.

168. CS-15 reported that Tellabs management needed to keep apprised of, and did keep apprised of, customer purchases and buying plans so that Tellabs and its customers could comply with federal regulations and Federal Communications Commission supplier diversity requirements. Quarterly reports described exactly what customers purchased and how much of the purchases was attributable to minority suppliers.

169. According to CS-16, the people working in Tellabs' mergers and acquisitions group would gather market data and market research, and speak with various companies in the field that were acquisition targets, and feed all this information to the head of the mergers and acquisitions group, Harvey Scull. In turn, Scull had conversations with Tellabs executive management, including Defendant Birck.

170. Defendants' knowledge was also evidenced by layoffs and Tellabs' cutting of projects. In April 2001, Tellabs began a process of laying off approximately 27% of its workforce. In addition, according to CS-9, information circulated throughout the Company in March 2001 that capital expenditures were going to be cut because sales were insufficient, and, just after the end of the Class Period, Tellabs did indeed cut all sorts of capital expense projects, including a $3 million project with which CS-9 was involved.

171. According to CS-3, the problems slowing the development of the TITAN 6500 were evident throughout the entire development process in 1998, 1999, 2000, and 2001, and thereafter. Defendants Jackman and Pullen and development personnel knew that the TITAN 6500 was not ready for deployment despite Tellabs' public announcements,

according to CS-3. As explained by CS-3, Tellabs introduced the TITAN 6500, prior to its being ready, in 2000; however, customers realized that the TITAN 6500 "was not even close to being ready" when they put the TITAN 6500 in their labs. According to CS-3, Notebaert also knew about this problem.

172. In the Company's 2001 Annual Report, Defendants effectively admitted that, by early 2001, they knew of the serious customer demand problems adversely affecting the Company's prospects. The Annual Report states: "Early in 2001, as our customers reduced capital spending and expressed caution about the future, Tellabs began a deep process of self-examination."

PLAINTIFFS' CLASS ACTION ALLEGATIONS

173. Plaintiffs bring this action as a class action pursuant to Federal Rule of Civil Procedure 23(a) and (b)(3) on behalf of all persons who purchased shares of Tellabs common stock during the Class Period (the "Class") and who were damaged thereby. Plaintiffs Broholm, LeBrun, Leehey, and Morris, also bring the claims asserted herein pursuant to Section 20A of the Exchange Act on behalf of the following subclasses:

a. Plaintiffs LeBrun and Leehey bring the claims asserted herein pursuant to Section 20A of the Exchange Act on behalf of a subclass ("LeBrun-Leehey Subclass") consisting of all Class members who purchased Tellabs common stock contemporaneously with sales of Tellabs common stock by Defendants Birck and Kohler on February 2, 2001.

b. Plaintiff Broholm brings the claims asserted herein pursuant to Section 20A of the Exchange Act on behalf of a subclass ("Broholm Subclass") consisting of all Class members who purchased Tellabs common stock contemporaneously with sales of Tellabs common stock by Defendant Birck on February 5, 2001.

c. Plaintiff Morris brings the claims asserted herein pursuant to Section 20A of the Exchange Act on behalf of a subclass ("Morris Subclass") consisting of all Class members who purchased Tellabs common stock contemporaneously with sales of Tellabs common stock by Defendant Birck on February 6, 2001.

174. Excluded from the Class are Defendants; the subsidiaries and affiliates of the Company; the officers and directors of the Company and its subsidiaries and affiliates; members of the immediate families of the Individual Defendants; the legal representatives, heirs, successors, or assigns of any excluded person; and any entity in which any excluded person has or had a controlling interest.

175. The members of the Class are so numerous that joinder of all members is impracticable. While the exact number of Class members is unknown to Plaintiffs at this time and can only be ascertained through appropriate discovery, Plaintiffs believe that there are thousands of members in the proposed Class. Throughout the Class Period, Tellabs common shares were actively traded on the NASDAQ National Market and there were approximately 188 million shares of Tellabs common stock issued and outstanding. Members of the Class may be identified from records maintained by Tellabs or its transfer agent, and may be notified of the pendency of this action by mail and publication, using forms of notice similar to those customarily used in securities class actions.

176. Plaintiffs' claims are typical of the claims of the members of the Class as all members of the Class are similarly affected by Defendants' wrongful conduct in violation of federal securities laws complained of herein.

177. Plaintiffs will fairly and adequately protect the interests of the members of the Class. Plaintiffs do not have any interests that conflict with the interests of other Class

Members and have retained counsel competent and experienced in class actions and securities litigation.

178. Common questions of law and fact exist as to all members of the Class and predominate over any questions solely affecting individual Class members. Among the questions of law and fact common to the Class are:

a. whether the federal securities laws were violated by Defendants' acts and omissions as alleged herein;

b. whether Defendants participated in and pursued the common course of conduct complained of herein;

c. whether statements made by Defendants to the investing public during the Class Period misrepresented and/or omitted to disclose material facts about the Company;

d. whether the market price for Tellabs common stock during the Class Period was artificially inflated due to the material misrepresentations and failures to correct the material misrepresentations complained of herein; and

e. whether the members of the Class have sustained damages and the proper measure of damages.

179. A class action is superior to all other available methods for the fair and efficient adjudication of this controversy because joinder of all members is impracticable. Furthermore, as the damages suffered by individual Class members may be relatively small, the expense and burden of individual litigation make it virtually impossible for many members of the Class to individually redress the wrongs done to them. There will be no difficulty in the management of this action as a class action.

APPLICABILITY OF PRESUMPTION OF RELIANCE: FRAUD-ON-THE-MARKET DOCTRINE

180. At all relevant times, the market for Tellabs common stock was an efficient market for the following reasons, among others:

- Tellabs common stock met the requirements for listing, and was listed and actively traded on the NASDAQ, a highly efficient and automated market;
- As a regulated issuer, Tellabs filed periodic public reports with the SEC and the NASDAQ;
- Tellabs regularly communicated with public investors through established market communication mechanisms, including regular dissemination of press releases on the national circuits of major newswire services and other wide-ranging public disclosures, such as communications with the financial press, securities analysts and other similar reporting services;
- Tellabs was followed by securities analysts employed by major brokerage firms who wrote reports which were distributed to the sales force and customers of their respective brokerage firms. Each of these reports was publicly available and entered the public marketplace, in part, through Tellabs' dissemination. Among the brokerage firms that issued research reports on Tellabs during the Class Period were Morgan Stanley Dean Witter & Co. ("Morgan Stanley"), Lehman Brothers, Inc. ("Lehman Bros."), Merrill Lynch Capital Markets ("Merrill Lynch"), UBS Warburg, LLC ("UBS Warburg"), and W.R. Hambrecht & Co. ("W.R. Hambrecht").

181. As a result, the market for Tellabs common stock promptly digested current information regarding Tellabs from all publicly available sources and reflected such information

in Tellabs' stock price. Under these circumstances, all purchasers of Tellabs shares during the Class Period suffered similar injury through their purchase of Tellabs shares at artificially inflated prices and a presumption of reliance applies. Further, Plaintiffs are entitled to and will rely on the presumption of reliance doctrine based on the material omissions alleged herein.

NO STATUTORY SAFE HARBOR

182. The statutory safe harbor provided for forward-looking statements under certain circumstances does not apply to any of the allegedly false statements pleaded in this Complaint. The specific statements pleaded herein are not "forward-looking statements" and were not identified as "forward-looking statements" when made. Nor was it stated with respect to any of the statements forming the basis of this Complaint that actual results "could differ materially from those projected." To the extent there were any forward-looking statements, there were no meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the purportedly forward-looking statements. Alternatively, to the extent that the statutory safe harbor does apply to any forward-looking statements pleaded herein, Defendants are liable for those false forward-looking statements because at the time each of those forward-looking statements were made, the particular speaker knew that the particular forward-looking statements was false, and/or the forward-looking statement was authorized and/or approved by an executive officer of Tellabs who knew that those statements were false when made.

TELLABS' GUIDANCE TO SECURITIES ANALYSTS AND USE OF THEM AS A CONDUIT TO PROVIDE FALSE INFORMATION TO THE SECURITIES MARKETS

183. As described herein, among other wrongful conduct, Defendants used communications with securities analysts to promote the Company and to artificially inflate the price of Tellabs common stock during the Class Period.

184. In writing their reports, these analysts relied in substantial part upon information provided by the Company, public statements and reports of the Company, information provided to them privately by the Company (including by the Individual Defendants) and assurances by the Company and the Individual Defendants that information in the analysts' reports did not materially vary from the Company's internal knowledge of its operations and prospects.

185. Defendants used their communications with analysts to assure them that their analysis and estimates of Tellabs' financial condition, performance, prospects, and business were accurate and repeatedly advised securities analysts that the Company was not adversely affected by a weakened economy and that revenues and earnings would continue to increase.

186. Prior to and during the Class Period, it was the Company's practice to have its top officers and key members of its management team communicate regularly with securities analysts to discuss, among other things, the Company's operating results and anticipated revenues and to provide detailed "guidance" to these analysts with respect to the Company's business and anticipated revenues and earnings. These communications included, but were not limited to, conference calls, meetings and analyst briefings where the Defendants discussed relevant aspects of the Company's operations and financial prospects. Additionally, Tellabs' representatives also

attended "conferences" sponsored by different organizations throughout the Class Period and sponsored "conference calls" with securities analysts and institutional investors in connection with releases of earnings announcements and other major corporate events during which they promoted the Company's stock by disseminating materially false and misleading information about the Company.

187. The Individual Defendants knew that, by participating in these regular and periodic direct communications with analysts, the Company would disseminate information to the investment community and that investors and the market would rely and act upon such information (*i.e.*, make purchases of the Company's securities). The Individual Defendants had these communications with analysts in order to cause or encourage them to issue favorable reports concerning Tellabs—which the analysts did—and Defendants used these communications to falsely present the financial condition, performance, business, and operations of Tellabs to the marketplace in an artificially and falsely favorable light in order to artificially inflate the market price for Tellabs common stock. Despite their duty to do so, the Individual Defendants failed to correct these communications of which they were the sources or which they had caused or facilitated during the Class Period.

188. The investment community, and, in turn, investors, relied and acted upon the information contained in these written analyst reports that repeatedly recommended that investors purchase Tellabs common stock. The Company and the Individual Defendants manipulated and inflated the market price of Tellabs stock by falsely presenting to analysts, through regular meetings and during both telephonic and written communications, the financial condition, earnings and revenues of the Company and by failing to disclose the true adverse facts about the Company that were known only to them.

COUNT I

VIOLATIONS OF SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 AGAINST ALL DEFENDANTS

189. Plaintiffs repeat and reallege each and every allegation contained above as if fully set forth herein.

190. During the Class Period, Defendants carried out a plan, scheme and course of conduct which was intended to and, throughout the Class Period, did: (i) deceive the investing public, including Plaintiffs and other Class members, as alleged herein; (ii) artificially inflate and maintain the market price of Tellabs' securities; and (iii) cause Plaintiffs and other members of the Class to purchase Tellabs' securities at artificially inflated prices. In furtherance of this unlawful scheme, plan and course of conduct, Defendants, and each of them, took the actions set forth herein.

191. Defendants: (a) employed devices, schemes, and artifices to defraud; (b) made untrue statements of material fact and omitted to state material facts necessary to make the statements not misleading; and (c) engaged in acts, practices, and a course of business that operated as a fraud and deceit upon the purchasers of the Company's securities in an effort to maintain artificially high market prices for Tellabs' securities in violation of Section 10(b) of the Exchange Act and Rule 10b-5. All Defendants are sued as primary participants in the wrongful and illegal conduct charged herein. The Individual Defendants also are sued as controlling persons as alleged below.

192. In addition to the duties of full disclosure imposed on Defendants as a result of their making of affirmative statements and reports, or participation in the making of affirmative statements and reports to the investing public, Defendants had a duty to promptly disseminate truthful information that would be material to investors in compliance

with the integrated disclosure provisions of the SEC as embodied in SEC Regulation S-X (17 C.F.R. Sections 210.01 et seq.) and Regulation S-K (17 C.F.R. Sections 229.10 et seq.) and other SEC regulations, including accurate and truthful information with respect to the Company's operations, financial condition and earnings so that the market price of the Company's securities would be based on truthful, complete and accurate information.

193. Tellabs and the Individual Defendants, individually and in concert, directly and indirectly, by the use of the means and instrumentalities of interstate commerce and of the mails, engaged and participated in a continuous course of conduct to conceal adverse material information about the business, operations, performance and prospects of Tellabs as specified herein.

194. These Defendants employed devices, schemes and artifices to defraud, while in possession of material adverse non-public information and engaged in acts, practices, and a course of conduct as alleged herein in an effort to assure investors of Tellabs' value and performance and continued substantial growth, which included the making of, or the participation in the making of, untrue statements of material facts and omitting to state material facts necessary in order to make the statements made about Tellabs and its business, operations, performance, and prospects in the light of the circumstances under which they were made, not misleading, as set forth more particularly herein, and engaged in transactions, practices and a course of business which operated as a fraud and deceit upon the purchasers of Tellabs' securities during the Class Period.

195. Defendants had actual knowledge of the misrepresentations and omissions of material facts set forth herein, or acted with reckless disregard for the truth in that they failed to ascertain and to disclose such facts, even though such facts were available to them. Defendants' material misrepresen-

tations and omissions were done knowingly or recklessly and for the purpose and effect of concealing Tellabs' operating condition and future business prospects from the investing public and supporting the artificially inflated price of its securities. As demonstrated by Defendants' overstatements and misstatements of the Company's business, operations, performance, and prospects throughout the Class Period, Defendants, if they did not have actual knowledge of the misrepresentations and omissions alleged, were reckless in failing to obtain such knowledge by deliberately refraining from taking those steps necessary to discover whether those statements were false or misleading.

196. As a result of the dissemination of the materially false and misleading information and failure to disclose material facts, as set forth above, the market price of Tellabs' securities was artificially inflated during the Class Period. In ignorance of the fact that market prices of Tellabs' publicly-traded securities were artificially inflated, and relying directly or indirectly on the false and misleading statements made by Defendants, or upon the integrity of the market in which the securities trade, or the absence of material adverse information that was known to or recklessly disregarded by Defendants but not disclosed in public statements by Defendants during the Class Period, Plaintiffs and the other members of the Class purchased Tellabs securities during the Class Period at artificially high prices and were damaged thereby.

197. At the time of said misrepresentations and omissions, Plaintiffs and other members of the Class were ignorant of their falsity, and believed them to be true. Had Plaintiffs and other members of the Class and the marketplace known of the true financial condition and business prospects of Tellabs, which were not disclosed by Defendants, Plaintiffs and other members of the Class would not have purchased their Tellabs securities, or, if they had purchased such securities during the Class Period, they would not have done so at the artificially inflated prices that they paid.

198. By virtue of the foregoing, Defendants have violated Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.

199. As a direct and proximate result of Defendants' wrongful conduct, Plaintiffs and the other members of the Class suffered damages in connection with their purchases of the Company's securities during the Class Period.

COUNT II

VIOLATIONS OF SECTION 20(a) OF THE EXCHANGE ACT AGAINST THE INDIVIDUAL DEFENDANTS

200. Plaintiffs repeat and reallege each and every allegation contained above as if fully set forth herein.

201. The Individual Defendants acted as controlling persons of Tellabs within the meaning of Section 20(a) of the Exchange Act as alleged herein. By virtue, among other things, of their high-level positions, their ownership of Company shares, and their participation in and awareness of the Company's operations and intimate knowledge of the statements filed by the Company with the SEC and disseminated to the investing public, the Individual Defendants had the power to influence and control and did influence and control, directly or indirectly, the decision-making of the Company, including the content and dissemination of the various statements that Plaintiffs contend are false and misleading. The Individual Defendants were provided with or had unlimited access to copies of the Company's reports, press releases, public filings, and other statements alleged by Plaintiffs to be materially false and misleading prior to or shortly after these statements were issued and had the ability to prevent the issuance of the statements or to cause the statements to be corrected.

202. In particular, the Individual Defendants had direct and supervisory involvement in the day-to-day operations of the Company and, therefore, are presumed to have had the power to control and influence the particular transactions giving rise to the securities violations as alleged herein, and exercised the same.

203. As set forth above, Tellabs and the Individual Defendants each violated Section 10(b) and Rule 10b-5 by their acts and omissions as alleged in this Complaint. By virtue of their positions each as controlling persons, the Individual Defendants are liable pursuant to Section 20(a) of the Exchange Act. As a direct and proximate result of Tellabs' and the Individual Defendants' wrongful conduct, Plaintiffs and other members of the Class suffered damages in connection with their purchases of the Company's securities during the Class Period.

COUNT III

VIOLATIONS OF SECTION 20A OF THE EXCHANGE ACT AGAINST DEFENDANTS BIRCK AND KOHLER

204. Plaintiffs repeat and reallege each and every allegation contained above as if fully set forth herein.

205. This Claim is brought by Plaintiffs LeBrun and Leehey on behalf of the LeBrun-Leehey Subclass against Defendants Birck and Kohler. Plaintiffs LeBrun and Leehey and each of the other members of the LeBrun-Leehey Subclass purchased Tellabs common stock contemporaneously with sales of Tellabs stock by Defendants Birck and Kohler on February 2, 2001.

206. By virtue of their positions as senior insiders of Tellabs, Individual Defendants Birck and Kohler were in possession of material, non-public information about Tellabs at the time they sold their own Tellabs stock to Plaintiffs

LeBrun and Leehey and the other members of the LeBrun-Leehey Subclass at artificially inflated prices.

207. By virtue of their participation in the scheme to defraud investors described herein, and their sales of stock while in possession of material, non-public adverse information about the Company, as detailed herein, Individual Defendants Birck and Kohler violated the Exchange Act and applicable rules and regulations thereunder.

208. Plaintiffs LeBrun and Leehey and all other members of the LeBrun-Leehey Subclass who purchased shares of Tellabs stock contemporaneously with the February 2, 2001 sales of Tellabs stock by Individual Defendants Birck and Kohler: (1) have suffered substantial damages in that they paid artificially inflated prices for Tellabs stock as a result of the violations of §§ 10(b) and 20(a) and Rule 10b-5 herein described; and (2) would not have purchased Tellabs stock at the prices they paid, or at all, if they had been aware that the market prices had been artificially inflated by Defendants' false and misleading statements.

209. Individual Defendants Birck and Kohler are required to account for all such stock sales and to disgorge their profits and ill-gotten gains.

COUNT IV

VIOLATIONS OF SECTION 20A OF THE EXCHANGE ACT AGAINST DEFENDANT BIRCK

210. Plaintiffs repeat and reallege each and every allegation contained above as if fully set forth herein.

211. This Claim is brought by Plaintiff Broholm on behalf of the Broholm Subclass against Defendant Birck. Plaintiff Broholm and each of the other members of the Broholm Subclass purchased Tellabs common stock contemporaneously with sales of Tellabs stock by Defendant Birck on February 5, 2001.

212. By virtue of his position as a senior insider of Tellabs, Individual Defendant Birck was in possession of material, non-public information about Tellabs at the time he sold his own Tellabs stock to Plaintiff Broholm and the other members of the Broholm Subclass at artificially inflated prices.

213. By virtue of his participation in the scheme to defraud investors described herein, and his sales of stock while in possession of material, non-public adverse information about the Company, as detailed herein, Individual Defendant Birck violated the Exchange Act and applicable rules and regulations thereunder.

214. Plaintiff Broholm and all other members of the Broholm Subclass who purchased shares of Tellabs stock contemporaneously with the sales of Tellabs stock by Individual Defendant Birck: (1) have suffered substantial damages in that they paid artificially inflated prices for Tellabs stock as a result of the violations of §§ 10(b) and 20(a) and Rule 10b-5 herein described; and (2) would not have purchased Tellabs stock at the prices they paid, or at all, if they had been aware that the market prices had been artificially inflated by Defendants' false and misleading statements.

215. Individual Defendant Birck is required to account for all such stock sales and to disgorge his profits and ill-gotten gains.

COUNT V

VIOLATIONS OF SECTION 20A OF THE EXCHANGE ACT AGAINST DEFENDANT BIRCK

216. Plaintiffs repeat and reallege each and every allegation contained above as if fully set forth herein.

217. This Claim is brought by Plaintiff Morris on behalf of the Morris Subclass against Defendant Birck. Plaintiff Morris

and each of the other members of the Morris Subclass purchased Tellabs common stock contemporaneously with sales of Tellabs stock by Defendant Birck on February 6, 2001.

218. By virtue of his position as a senior insider of Tellabs, Individual Defendant Birck was in possession of material, non-public information about Tellabs at the time he sold his own Tellabs stock to Plaintiff Morris and the other members of the Morris Subclass at artificially inflated prices.

219. By virtue of his participation in the scheme to defraud investors described herein, and his sales of stock while in possession of material, non-public adverse information about the Company, as detailed herein, Individual Defendant Birck violated the Exchange Act and applicable rules and regulations thereunder.

220. Plaintiff Morris and all other members of the Morris Subclass who purchased shares of Tellabs stock contemporaneously with the sales of Tellabs stock by Individual Defendant Birck: (1) have suffered substantial damages in that they paid artificially inflated prices for Tellabs stock as a result of the violations of §§ 10(b) and 20(a) and Rule 10b-5 herein described; and (2) would not have purchased Tellabs stock at the prices they paid, or at all, if they had been aware that the market prices had been artificially inflated by Defendants' false and misleading statements.

221. Individual Defendant Birck is required to account for all such stock sales and to disgorge his profits and ill-gotten gains.

COUNT VI

VIOLATIONS OF SECTION 20A OF THE EXCHANGE ACT AGAINST DEFENDANT KOZIK

222. Plaintiffs repeat and reallege each and every allegation contained above as if fully set forth herein.

223. This Claim is brought by Plaintiff Heaton on behalf of the Heaton Subclass against Defendant Kozik. Plaintiff Heaton and each of the other members of the Heaton Subclass purchased Tellabs common stock contemporaneously with sales of Tellabs stock by Defendant Kozik on February 15, 2001.

224. By virtue of her position as a senior insider of Tellabs, Individual Defendant Kozik was in possession of material, non-public information about Tellabs at the time she sold her own Tellabs stock to Plaintiff Heaton and the other members of the Heaton Subclass at artificially inflated prices.

225. By virtue of his participation in the scheme to defraud investors described herein, and his sales of stock while in possession of material, non-public adverse information about the Company, as detailed herein, Individual Defendant Kozik violated the Exchange Act and applicable rules and regulations thereunder.

226. Plaintiff Heaton and all other members of the Heaton Subclass who purchased shares of Tellabs stock contemporaneously with the sales of Tellabs stock by Individual Defendant Kozik: (1) have suffered substantial damages in that they paid artificially inflated prices for Tellabs stock as a result of the violations of §§ 10(b) and 20(a) and Rule 10b-5 herein described; and (2) would not have purchased Tellabs stock at the prices they paid, or at all, if they had been aware that the market prices had been artificially inflated by Defendants' false and misleading statements.

227. Individual Defendant Kozik is required to account for all such stock sales and to disgorge her profits and ill-gotten gains.

COUNT VII

VIOLATIONS OF SECTION 20A OF THE EXCHANGE ACT AGAINST DEFENDANT GRUENWALD

228. Plaintiffs repeat and reallege each and every allegation contained above as if fully set forth herein.

229. This Claim is brought by Plaintiff Mackay on behalf of the Mackay Subclass against Defendant Gruenwald. Plaintiff Mackay and each of the other members of the Mackay Subclass purchased Tellabs common stock contemporaneously with sales of Tellabs stock by Defendant Gruenwald on January 31, 2001.

230. By virtue of his position as a senior insider of Tellabs, Individual Defendant Gruenwald was in possession of material, non-public information about Tellabs at the time he sold his own Tellabs stock to Plaintiff Mackay and the other members of the Mackay Subclass at artificially inflated prices.

231. By virtue of his participation in the scheme to defraud investors described herein, and his sales of stock while in possession of material, non-public adverse information about the Company, as detailed herein, Individual Defendant Gruenwald violated the Exchange Act and applicable rules and regulations thereunder.

232. Plaintiff Mackay and all other members of the Mackay Subclass who purchased shares of Tellabs stock contemporaneously with the sales of Tellabs stock by this Individual Defendant: (1) have suffered substantial damages in that they paid artificially inflated prices for Tellabs stock as a result of the violations of §§ 10(b) and 20(a) and Rule 10b-5 herein described; and (2) would not have purchased Tellabs stock at the prices they paid, or at all, if they had been aware that the market prices had been artificially inflated by Defendants' false and misleading statements.

233. Individual Defendant Greenwald is required to account for all such stock sales and to disgorge his profits and ill-gotten gains.

WHEREFORE, Plaintiffs pray for relief and judgment, as follows:

a. Determining that this action is a proper class action under Rule 23 of the Federal Rules of Civil Procedure and certifying Plaintiffs as representatives of the Class and Sub-Classes defined herein;

b. Awarding compensatory damages in favor of Plaintiffs and other Class members against all Defendants, jointly and severally, for all damages sustained as a result of Defendants' wrongdoing, including, but not limited to, the Individual Defendants' insider trading, in an amount to be determined at trial, including interest thereon;

c. Awarding Plaintiffs and the Class their costs and expenses incurred in this action, including counsel fees and expert fees;

d. Awarding pre-judgment and post-judgment interest as allowed by law; and

e. Such other and further relief as the Court may deem just and proper.

JURY TRIAL DEMANDED

Plaintiffs hereby demand a trial by jury on all issues so triable.

Dated: July 11, 2003

By: /s/ Marvin A. Miller

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No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD C. NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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February 9, 2007

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20002

QUESTION PRESENTED

Whether, and to what extent, a court must consider or weigh competing inferences in determining whether a complaint asserting a claim of securities fraud has alleged facts sufficient to establish a "strong inference" that the defendant acted with scienter, as required under the Private Securities Litigation Reform Act of 1995.

PARTIES TO THE PROCEEDING

Petitioners, defendants-appellees below, are Tellabs, Inc. and Richard C. Notebaert. Additional defendants-appellees below were Michael J. Birck, Joan E. Ryan, Brian J. Jackman, Robert W. Pullen and John C. Kohler, all of whom are former officers or directors of Tellabs, Inc.

Tellabs, Inc. has no parent company, and no publicly held company owns 10 percent or more of its stock.

Respondents are Makor Issues & Rights, Ltd., a corporation appointed as lead plaintiff, and appellant below, and the individuals Chris Broholm, Richard LeBrun, David Leehey and Patricia Morris, all of whom purport to act on behalf of themselves and a class of persons similarly situated.

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OPINIONS BELOW

The opinion of the United States District Court for the Northern District of Illinois dismissing respondents' Second Consolidated Amended Class Action Complaint ("Second Amended Complaint" or "Complaint") was reported at 303 F. Supp. 2d 941 (N.D. Ill. 2004), and is reproduced at Pet. App. 28a-79a. The modified opinion of the United States Court of Appeals for the Seventh Circuit was reported at 437 F.3d 588 (7th Cir. 2006), and is reproduced at Pet. App. 1a-27a.

JURISDICTION

The court of appeals issued its original opinion on January 25, 2006. Petitioners timely sought rehearing, which resulted in an order, dated July 10, 2006, modifying the original opinion. Petitioners timely filed their petition on October 3, 2006, which was granted on January 5, 2007. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254.

STATUTORY PROVISION INVOLVED

Section 21D of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-4, was added by the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 747. Section 21D provides, in pertinent part:

> (2) REQUIRED STATE OF MIND.—In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

STATEMENT OF THE CASE

The Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 ("Reform Act"), was passed by Congress to deter and defeat strike suits containing weakly grounded claims under the federal securities laws. The provision of the Reform Act at issue in this case is the requirement that a complaint allege particularized facts giving rise to a "strong inference" that the defendant acted with the culpable mental state required for liability. 15 U.S.C. § 78u-4(b)(2). The culpable mental state required to support a securities fraud claim is generally referred to as "scienter." *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

The Seventh Circuit in this case interpreted and applied the "strong inference" standard in a way that is inconsistent with its text and purpose. The court of appeals adopted an approach to a securities fraud complaint that rewards ambiguous pleading by reading such allegations exclusively in the plaintiff's favor, and one-sidedly considers the strength of claimed inferences of scienter by themselves, without placing the allegations putatively supporting such an inference in the context provided by the complaint and other materials properly before the court.

Contrary to the Seventh Circuit's approach, the Reform Act requires a plaintiff to plead specific facts that, considered in the overall context created by the complaint as a whole and other materials properly before the court, demonstrate that the plaintiff's claim that the defendant acted with scienter has substantial merit. Facts that, even when assumed to be true, are no more than ambiguous regarding the defendant's mental state—that are at best equally consistent with both innocence and culpability—are insufficient. The complaint here falls well below the Reform Act's heightened standard, and actually provides a model of how *not* to plead a securities fraud case under the Reform Act. This Court should reverse

the decision below, and order that the district court's dismissal of the complaint be affirmed.

A. Factual Background.

Petitioner Tellabs, Inc. ("Tellabs" or the "Company") designs highly specialized optical networks and broadband access equipment, which it markets to telecommunications carriers and internet service providers. JA 94, ¶ 2. Petitioner Richard C. Notebaert ("Notebaert") served as Chief Executive Officer and President of Tellabs during the relevant time period. *Id.* at 98, ¶ 20. Respondents, representing a proposed class of Tellabs stockholders, sued Tellabs and several of its officers and directors under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, and Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a), alleging that defendants had engaged in a scheme to inflate Tellabs' stock price for the seven-month period from December 11, 2000 through June 19, 2001.[1]

Respondents alleged that the internet and telecommunications sectors experienced a significant decline in demand beginning in the middle of 2000. JA 94, ¶ 3. As a result, Tellabs' customers "were suffering from a severe deterioration and consolidation of their businesses." *Id.* at 95, ¶ 4.

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[1] Joan Ryan (Tellabs' Chief Financial Officer during the relevant period) and Brian Jackman remain defendants only to a "control person" claim under Section 20(a), the Section 10(b) claims against them having been dismissed with no appeal taken by respondents. The Section 10(b) claim against Michael Birck, the Company's Chairman of the Board, has also been dismissed (with affirmance) but he remains a defendant to a Section 20(a) "control person" claim, as well as to a claim under Section 20A of the Securities Exchange Act of 1934, 15 U.S.C. § 78t-1(a). Pet. App. 26a-27a. These claims under Section 20(a) and Section 20A are all derivative of the Section 10(b) claims against Notebaert and the Company. While Robert W. Pullen and John C. Kohler were previously defendants in this matter, respondents expressly elected not to pursue any appeal as to them from the district court's prior dismissal rulings.

Essentially, respondents alleged that petitioners disguised the impact this decline had on Tellabs by falsely assuring investors that Tellabs' actual and expected performance remained strong.

During 2000, internet traffic significantly increased, resulting in increased demand for Tellabs' specialized network systems designed to carry such traffic. As a result, Tellabs enjoyed record sales of more than $3.3 billion in 2000, a 43% increase over 1999. JA 134, ¶ 107. Sales of its optical networking products (the key one of which was the TITAN 5500) increased by 54.1% compared to 1999. *Id.* Anticipating continued increases in internet usage and its own continued strong growth, on December 11, 2000, Tellabs projected an overall 30% growth in sales during 2001. *Id.* at 114-15, ¶¶ 75-76.

Starting on March 7, 2001, and continuing through the end of the class period (June 19, 2001), Tellabs revised its projections downward several times. Tellabs initially reduced its projections of first quarter sales slightly on March 7, 2001, announcing "below-trend growth in Tellabs' CABLESPAN® business"—a separate business line that is not the subject of any allegations here—and an inability to recognize revenue in the quarter from shipments of its new TITAN 6500 system. JA 15. On April 6, 2001, Tellabs announced a more significant reduction in its first quarter guidance, projecting sales for that quarter of about $772 million, compared with prior guidance in the range of $830 million to $865 million. *Id.* at 31. In its April 6 press release, the Company stated that "[t]he revised guidance stems from reduced and deferred spending by major communications carriers late in the quarter." *Id.* During a call with analysts that same day, Notebaert explained that in the last two and a half weeks of the quarter, certain customers had pushed some TITAN 5500 orders into the next quarter. *Id.* at 36-37. He further stated that, "[c]learly, the environment has resulted in near term caution in the pace at which customers are deploying

equipment. Our customers are exercising a high degree of prudence over every dollar spent." *Id.* at 34.

On April 18, 2001, Tellabs announced its first quarter financial results. JA 43. Although below original guidance, the results showed that the Company was still experiencing significant growth, with an increase in sales for the quarter of 21% over the same quarter from the prior year. *Id.* These results are not alleged to have been false. Pet. App. 64a.

Also on April 18, 2001, the Company reduced its full-year revenue projections from approximately $4.4 billion to a range of $3.6 to $3.7 billion. JA 44. The Company attributed the revised projections to "reduced and deferred spending by major communications carriers." *Id.* at 43. Later that day, Notebaert told analysts:

> Declining business trends we experienced late in the quarter indicate[] that we are operating in a very different environment than we were just a few short months ago. In fact, a very different environment than it was just a few weeks ago. Our customers are reviewing, and in some cases, reducing capital spending plans ....

Id. at 51.

Respondents contend that the "truth" became known on June 19, 2001. On that date, Tellabs announced substantial reductions in its prior guidance as to the second quarter and withdrew its prior guidance for the remainder of 2001. JA 144, ¶ 131. As alleged in the Complaint, the revenue shortfall for the second quarter was "due almost entirely" to a reduction in sales of the TITAN 5500 product. *Id.* at 145, ¶ 132.

According to the Seventh Circuit, the Complaint adequately stated a claim under Section 10(b) only as to Notebaert and, derivatively, the Company. Pet. App. 22a. Notebaert is not alleged to have financially benefited personally from any purported inflation in stock price during the putative class

period, nor to have attempted to do so. And the Company is not alleged to have derived any benefit at all from the seven-month period that its financial projections were allegedly inflated before voluntarily concluding a process of guidance reductions (begun during the class period) which brought its financial outlook to what are admitted to be truthful levels. Nonetheless, at issue here are those allegations that putatively give rise to a "strong inference" of scienter as to Notebaert with respect to specific false statements he is alleged to have made.

There are three categories of Notebaert's allegedly misleading statements.[2] First, statements regarding Tellabs' financial results for the fourth quarter of 2000 are alleged to have been false. Second, Notebaert is alleged to have misleadingly stated the strength of customer demand for the TITAN 5500 system, which was, at the time, Tellabs' principal product. (For the same reason, the Complaint alleges that the Company's financial projections during the class period were false.) Third, Notebaert is alleged to have misleadingly stated the availability of and demand for the TITAN 6500 system, which was then one of Tellabs' new products.

1. Respondents allege that Tellabs' financial results for the fourth quarter of 2000 were falsely inflated due to "channel stuffing" with respect to the TITAN 5500. JA 122, ¶ 86(a); *see also id.* at 128, 136, ¶¶ 95, 112. The Complaint defined "channel stuffing" broadly to include, *inter alia*, not only writing orders for products that customers did not want, but also offering discounts and incentives to entice customers to purchase products during the fourth quarter.[3] *Id.* at 110, ¶ 62.

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[2] The allegedly misleading statements by Notebaert discussed throughout are those that survived the Seventh Circuit's review.

[3] The Complaint also alleged in conclusory fashion that Tellabs had improperly back-dated orders, JA 110, ¶ 62, but the court of appeals

On the critical question of Notebaert's scienter, the Complaint alleges only that Notebaert "worked directly with Tellabs' sales personnel to channel stuff" and that he "unquestionably knew about the channel stuffing activity relating to the TITAN 5500." JA 111, 157, ¶¶ 67, 156. The Complaint does not specify which type of "channel stuffing" activity Notebaert allegedly knew about, however, or what it is he supposedly did when he "worked directly" with Tellabs' sales personnel. This failure is significant because, as the district court recognized, there is nothing improper in offering discounts and incentives to customers, which respondents had included in their definition of "channel stuffing." Pet. App. 58a, 74a. "Working with" sales personnel to "channel stuff" could thus refer to nothing more than Notebaert having participated in fashioning customer discounts. The lack of detail as to Notebaert was especially significant because the Complaint specifies alleged instances of Tellabs sending customers products they did not want. JA 111, ¶ 68. But the Complaint does not allege that Notebaert knew of those instances in particular, or of anything like them. Nothing more precise is alleged than that Notebaert knew of the broadly defined "channel stuffing."

2. Respondents have alleged that Notebaert three times misleadingly expressed continued confidence in demand for the TITAN 5500. First, in Tellabs' Annual Report for the year 2000, which was issued on February 14, 2001, Notebaert responded to a frequently asked question: "'[A]re you worried that [the TITAN 5500] has peaked'" by stating, "'No.... Although we introduced this product nearly 10 years ago, it's still going strong.'" JA 126, ¶ 91 (emphasis omitted). Second, on March 8, 2001, Notebaert allegedly responded to an analyst question about whether Tellabs was experiencing any weakness in TITAN 5500 product sales by saying, "'We're still seeing that product continue to maintain its growth rate;

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concluded that the Complaint did not provide any specifics supporting that conclusory allegation. Pet. App. 13a.

it's still experiencing strong acceptance.'" *Id.* at 132, ¶ 102 (emphasis omitted). Third, on April 6, 2001, in a conference call with analysts announcing a reduction in the Company's first quarter estimates—a reduction expressly attributed to the Company having received fewer customer orders than anticipated in the last two and a half weeks of March, and an environment in which customers were exercising greater caution with respect to spending[4]—Notebaert stated the following: "'Let me balance this a bit and say that everything we hear from our customers indicates that our in-user demand for services continues to grow.'" *Id.* at 137, ¶ 114 (emphasis omitted).[5]

The allegations with respect to Notebaert's scienter are, once again, noticeably vague. According to the Complaint, Notebaert knew his putative statements of confidence in customer demand for the TITAN 5500 were false because Tellabs had commissioned a report by Probe Research which concluded that the main source of demand for the TITAN 5500 was declining. JA 103-04, ¶ 39. In addition, a Tellabs internal marketing report allegedly concluded that TITAN 5500 revenue would decline by approximately $400 million. *Id.* But while the Complaint specifies the dates on which

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[4] "In just the last few weeks, however, we experienced a more controlled order of flow from our larger customers than we had originally anticipated. Clearly the environment has result[ed] in near-term caution in the pace at which customers are deploying equipment. Our customers are exercising a high degree of prudence over every dollar spent." JA 137, ¶ 114 (emphasis omitted) (alteration in original).

[5] The Complaint's reference to "in-user" demand for services actually refers to a comment regarding "end user" demand for services. JA 34. Regardless of the term, the context makes clear that the persons being referred to are not Tellabs' customers, but rather, the customers of those customers, whose demand for internet and other services was continuing to grow. Notebaert was pointing out that, despite the fact that ultimate "end user" demand for internet services was growing, Tellabs' own customers were increasingly cautious about purchasing new equipment. *Id.*

Notebaert allegedly falsely expressed confidence in customer demand, the Complaint fails to specify the date the Probe Research Report was received by Tellabs, or when the internal marketing report was prepared. It says only that the Probe Research Report was "*completed* in or about early 2001," and the marketing report was prepared "[i]n or about early 2001." *Id.* (emphasis added). In addition, the Complaint nowhere alleges whether the conclusions contained in either report were ever communicated to Notebaert, or if so, when.

Respondents also alleged that a confidential source reported that Tellabs had produced "internal quarterly reports" that "showed a decline in customer demand for the TITAN 5500 in March 2001." JA 104, ¶ 40. Once again, the Complaint does not specify *when* in March these internal reports first showed a decline. This omission too is significant because on April 6 Notebaert had publicly announced that there was a fall-off in orders for the TITAN 5500 *during the last two and a half weeks of March. Id.* at 34, 36-37.

3. With respect to the TITAN 6500, respondents alleged that on March 8, 2001, Notebaert falsely stated that "'[i]nterest in and demand for the 6500 continues to grow.... We continue to ship the ... 6500 through the first quarter. We are satisfying very strong demand and growing customer demand.'" JA 131, ¶ 100 (emphasis omitted). And, on April 6, 2001, in response to an analyst question whether Tellabs was on track to recognize its first revenue from the TITAN 6500 in the second quarter, Notebaert stated that, "'we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong ....'" *Id.* at 138, ¶ 117 (emphasis omitted).

Only a single paragraph of the Complaint alleges any facts relevant to Notebaert's scienter with respect to his allegedly false statements regarding the TITAN 6500. JA 107-08, ¶ 53. The allegations in that paragraph are all based on a single confidential source who was no longer with the Company at

the time that *any* of the allegedly false statements with respect to the TITAN 6500 were made. *Id.* at 91. According to the confidential source, the TITAN 6500 had suffered through a variety of development problems from 1998 through 2001, "and thereafter." *Id.* at 107, ¶ 53. The only sentence discussing Notebaert's knowledge of problems with the TITAN 6500 is conspicuously vague: "Notebaert also knew about the TITAN 6500 problems." *Id.* at 108, ¶ 53. The Complaint does not identify what problems Notebaert allegedly knew about, when he knew about them, or explain how the confidential source—who was no longer with the Company—could have known what information was available to or known by Notebaert in the spring of 2001.

B. Decisions Below.

1. After the district court appointed Makor Issues & Rights, Ltd. as lead plaintiff and approved its choice of lead counsel, respondents filed a Consolidated Amended Class Action Complaint on December 3, 2002. JA 2. The district court dismissed that complaint without prejudice on May 19, 2003, and plaintiffs filed the Second Amended Complaint (the operative Complaint here) on July 11, 2003. *Id.* at 3. The district court dismissed respondents' Second Amended Complaint in its entirety and with prejudice on February 19, 2004. Pet. App. 28a-79a.

As relevant here, the district court concluded that the Complaint adequately alleged that certain statements regarding the TITAN 5500 and the TITAN 6500 were false, including Notebaert's statements discussed above. The district court further concluded that the Complaint adequately alleged that Tellabs' fourth quarter 2000 financial statements improperly included revenues from unordered products shipped to certain customers during that quarter.[6]

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[6] The district court also ruled that, with the exception of the December 2000 revenue projection, Tellabs' projections during the class period were not actionable because they were protected by the Reform Act's safe

The district court then examined the Complaint's allegations of scienter with respect to each individual defendant, and concluded that they were insufficient to give rise to a strong inference of scienter. With respect to the allegations that Notebaert knew that Tellabs' fourth quarter 2000 financial statements were falsely inflated due to channel stuffing, the district court held that the conclusory allegations that Notebaert knew about and participated in some type of "channel stuffing" were insufficient to create a strong inference that Notebaert knew of any *improper* "channel stuffing." Pet. App. 74a. The court noted that the Complaint did not specify what channel stuffing activities Notebaert allegedly participated in: "Such allegations are critical because the Court has concluded that there is nothing inherently wrong with several of Plaintiffs' channel stuffing allegations." *Id.* In fact, the district court had, in its prior ruling dismissing the earlier complaint, told the plaintiffs that their allegations of scienter regarding "channel stuffing" inappropriately encompassed conduct that was innocent. *Id.* at 99a-100a.

The district court also considered the Complaint's allegations regarding the Probe Research Report and the internal marketing reports. In concluding that the allegations regarding these reports did not support a strong inference of Notebaert's scienter, the district court noted that the allegations lacked "significant details," including the precise dates of these reports, which were important given the chronology of statements. Pet. App. 65a.

Finally, the district court concluded that the Complaint's general allegations regarding "Notebaert's position in the company and general conclusions concerning his knowledge of the allegedly fraudulent activities without providing

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harbor. Pet. App. 45a (citing 15 U.S.C. § 78u-5(c)(1)(A)(i) & (ii)). The Seventh Circuit disagreed and concluded that none of the projections was protected by the Reform Act's safe harbor. *Id.* at 16a. This issue is not before this Court.

particulars to reinforce their general conclusions" could not support a strong inference of scienter with respect to any of the alleged misstatements, including the statements regarding the TITAN 6500. Pet. App. 74a.

2. Respondents appealed. The Seventh Circuit reversed the district court's dismissal of the Section 10(b) claims as to Notebaert and, derivatively, the Company. After identifying the allegedly false statements that were pled with sufficient specificity potentially to support a claim, Pet. App.10a-16a, the court of appeals turned to the issue of scienter.

The court focused on "the degree of imagination courts can use in divining whether a complaint creates a 'strong inference.'" Pet. App. 20a. The Seventh Circuit concluded that a complaint should survive "if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." *Id.*

The Seventh Circuit then applied this reasonable person standard to the Complaint's allegations regarding Notebaert.[7] The court concluded that allegations that Notebaert "knew" about and "'worked directly with Tellabs sales personnel'" to effect "channel stuffing" were sufficient to establish a strong inference that Notebaert knew that purchase orders had been fabricated for products that certain customers had not ordered, and therefore knew that Tellabs' fourth quarter 2000 financial

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[7] The only other individual defendant as to whom respondents appealed the dismissal of their Section 10(b) claim was Michael Birck, Tellabs' Board Chairman. The court held that the Complaint did not adequately allege facts supporting the claim that Birck acted with scienter. The only statement attributed to Birck was a February 2001 statement informing investors that the TITAN 5500 was "'still going strong.'" The court determined, however, that "it was not until March 2001 that the TITAN 5500's declining status was obvious." Pet. App. 24a. The court also determined that the Complaint's allegations regarding Birck's alleged insider trading lacked sufficient particularity. Pet. App. 23-24a.

statements were misstated.[8] Pet. App. 25a. The court simply ignored what the district court had twice pointed out: that the allegations of "channel stuffing" were broad enough to include innocent conduct (offering discounts and incentives to customers) that would not support an inference of scienter at all, and that no specificity whatsoever had been provided as to what exactly Notebaert had allegedly done or known.

In addressing the allegations that Notebaert knew that his statements regarding the TITAN 5500 were false when made, the Seventh Circuit relied on allegations with respect to the Probe Research Report and certain internal reports. The court recognized that under the Complaint's allegations it was "conceivable" that Notebaert had not seen these reports when he made his statements. Nonetheless, the court found that "plaintiffs have provided enough for a reasonable person to infer that Notebaert knew that his statements were false." Pet. App. 23a. The court noted, but quickly set aside, the vagueness of the allegations regarding the timing of both the Probe Research Report and the internal reports, focusing instead on the general notion that Notebaert "stayed on top of the company's financial health" and that the TITAN 5500 was an important product to the Company. *Id.* Such general and vague allegations were, according to the court, sufficient to create a strong inference of scienter.

Finally, with respect to Notebaert's statements regarding the TITAN 6500, the court simply misstated the allegations of the Complaint. The court believed that a confidential informant had alleged that Notebaert "knew that 'the TITAN 6500 was not ready for deployment despite Tellabs' public announcements.'" Pet. App. 25a (alteration omitted). That

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[8] The Seventh Circuit found that the only claim that respondents had pleaded with sufficient particularity in regard to the alleged falsity of the fourth quarter 2000 financial statements was that certain of Tellabs' customers had been sent unordered TITAN 5500s. Pet. App. 25a.

was incorrect.[9] Only one sentence in the Complaint directly talked about Notebaert and the TITAN 6500, and it stated only that, according to a source, Notebaert knew of "problems" with the TITAN 6500, without specifying which "problems" Notebaert knew of or how. JA 107-108, ¶ 53. This absence of detail was signifcant because the source had admittedly left the Company prior to the class period, and referred to problems with the development of the product dating back to 1998. *Id.* The Seventh Circuit also relied on an allegation that Notebaert "saw weekly sales reports and production projections," Pet. App. 24a-25a, which is actually a combination of two different allegations, neither of which makes any specific reference to the TITAN 6500. One refers to a generalized allegation that "Tellabs management viewed weekly and monthly reports concerning a variety of issues, including the status of product development." JA 155, ¶ 153(f) (emphasis omitted). The other specifically mentions Notebaert, but alleges only that he "had telephone calls every day and stayed on top of everything," and that he had discussions with other executives who had weekly revenue calls. *Id.* at 155-56, ¶ 153(g). The court nonetheless concluded that these generalized allegations supported a "strong inference" of scienter. Pet. App. 25a.

The Seventh Circuit not only accepted the patently ambiguous allegations regarding Notebaert's alleged scienter, but it ignored the broader context that undermined whatever weak inference of scienter otherwise existed. The court simply ignored the fact that Tellabs reduced its revenue projections repeatedly during a period in which it was alleged to have been artificially inflating its stock price by creating false expectations. In addition, the Seventh Circuit never

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[9] The Complaint actually alleges that two other defendants, Jackman and Pullen, whose dismissals with respect to the Section 10(b) claims were not challenged on appeal by respondents, knew that the TITAN 6500 was not ready for disbursement despite public announcements to the contrary. JA 107, ¶ 53.

acknowledged or addressed the fact that the Complaint had not alleged any motive for Notebaert artificially to have inflated Tellabs' stock price for a limited seven-month period during which neither he nor the Company is alleged to have derived any financial benefit from the fraud. Instead, the ambiguous allegations discussed above, viewed without reference to the full picture drawn by the Complaint and other materials properly before the court, were deemed sufficient to satisfy the "strong inference" standard.

SUMMARY OF ARGUMENT

The plain language of the Reform Act makes clear that Congress intended to change the pleading paradigm with respect to allegations of scienter in securities fraud cases. By requiring plaintiffs to "state with particularity facts giving rise to a strong inference" of scienter, 15 U.S.C. § 78u-4(b)(2), Congress signaled a clear break from the general notice-pleading rule embodied in Fed. R. Civ. P. 8(a) and the permissive rule regarding general averments of intent in Fed. R. Civ. P. 9(b).

Congress has heightened the pleading burden with respect to allegations of scienter for a private plaintiff asserting a claim of securities fraud under the 1934 Act in two critical respects. First, the "particularity" requirement requires a plaintiff to plead specific facts from which an inference that the defendant acted with scienter may be drawn. Rule 9(b), which on its face permits general averments of a defendant's mental state, is thus superseded in federal securities fraud cases. Second, and of central concern in this case, the specifically pled facts must create a "strong" inference of scienter. Determining the strength of the inference of scienter requires a court to consider the plausibility of the assertion that the defendant acted with scienter in light of the specific facts pled—including facts that serve to undermine any such claimed inference. This requirement is a fundamental shift away from the familiar role of a modern complaint, which, in

the typical case, need only provide notice of the basic nature and circumstances of the claim. By contrast, the Reform Act imposes a burden on the plaintiff to plead specific facts that, if proven to be true, cogently demonstrate a substantial claim as to scienter that meaningfully tends to exclude innocent possibilities. Thus, if a plaintiff is able to do no more than allege facts that are, at most, equally consistent on their face with either innocence or culpability—despite the benefit of having all well-pleaded facts treated as true, and being the master of what to include in the complaint—a "strong inference" of scienter does not exist and the complaint should be dismissed.

The requirement that a federal securities fraud pleading paint a cogent picture of the substantial merit of the plaintiff's claim of scienter is critical to advancing the fundamental purpose of the Reform Act. Through the Reform Act, Congress sought to deter and defeat the abusive practice of securities fraud strike suits. Congress perceived that the typical roadblocks against insubstantial claims, discovery and summary judgment, were not effectively weeding out meritless securities fraud claims. Congress concluded that the high costs of discovery, and the potential bet-the-company nature of securities fraud suits, too often forced companies to settle even meritless claims for substantial sums whenever a complaint survived a motion to dismiss on the pleadings. The result was a legal regime that undermined the goals that the securities laws are supposed to advance, in particular encouraging a free-flow of information delivered to the market regarding publicly traded companies. An omnipresent threat of litigation discourages public statements about a company's future prospects. By requiring plaintiffs to plead facts sufficient to show a substantially meritorious scienter claim, Congress changed this perverse legal environment.

In light of the Reform Act's language and purpose, certain principles emerge for evaluating whether a securities fraud complaint's allegations give rise to a "strong inference" of

scienter. First, a court should consider and weigh all the allegations of the complaint, along with all other materials properly before it, including facts that support an inference of innocence. Even if a well pled fact might support some inference of scienter in isolation, the inference may not be "strong" in light of the overall context, including other facts properly before the court. Any rule that permits courts to ignore the facts that suggest an innocent mental state would allow precisely the kinds of doubtful, speculative claims to proceed that Congress clearly intended to deter and prevent.

Second, the absence of certain allegations from a complaint is also relevant. In particular, both before and after the Reform Act, courts have appropriately recognized that the presence or absence of allegations of motive to engage in fraud is particularly important for determining whether the complaint creates a "strong inference" of scienter. The absence of a cogent economic motive to engage in unlawful conduct substantially weakens any inference of scienter, because courts do not lightly assume that individuals behave illegally for no reason. Once again, allowing such claims to proceed would reintroduce the harms of weakly grounded claims that Congress intended to eliminate.

Third, the language and purpose of the Reform Act require that certain commonly employed, ambiguous pleading strategies not count in a plaintiff's favor. Allegations that are as consistent with innocence as with culpability do not satisfy the "strong inference" requirement and should not suffice to survive a motion to dismiss; rather, the facts alleged must meaningfully tend to exclude the possibility of innocence. There are at least two different types of such ambiguous allegations. What might be called "strategic ambiguity" leaves out significant details that would clarify whether the identified conduct was either innocent or culpable. Other ambiguous allegations include facts that one might expect to be true in the event the defendant acted illegally, but one would also expect to see even if the defendant were acting

innocently. Both types of ambiguous allegations do no more than raise the possibility of scienter, without meaningfully tending to exclude innocent explanations. Allowing claims based on such allegations to proceed would effectively reinstitute the pre-existing regime that Congress rejected for securities fraud claims. Congress did not wish to wait until later in the litigation to allow the plaintiff to uncover facts that tend to exclude an innocent explanation.

A review of the allegations in the Second Amended Complaint, in light of the "strong inference" standard properly construed, reveals that the Seventh Circuit erred in ordering the case to proceed. The Seventh Circuit repeatedly credited ambiguities in respondents' favor and ignored all facts that undercut the scienter charge.

Respondents claim, for example, that Notebaert knew his statements regarding demand for the TITAN 5500 were false because they have alleged that a report by Probe Research, as well as certain internal reports, stated that 2001 revenue for the TITAN 5500 would decline. But, critically, the Complaint does not allege with precision when these reports were delivered or when, if ever, their conclusions were made known to Notebaert. As a result of this ambiguity, these allegations are at most equally consistent with innocence and culpability; yet the Seventh Circuit indulged respondents. What is more, during the seven-month period of alleged fraud, Notebaert caused the Company to revise *downward* its projections several times, including in April 2001, when he publicly announced a fall-off in orders experienced in the latter part of March and reduced projected revenues for the year by $800 million (approximately 18%). This conduct, which is entirely inconsistent with the alleged scheme to defraud, fatally undermines even the ambiguous and weak inference of scienter that can be drawn from the facts alleged; but the Seventh Circuit declined to take any account of it.

Similarly ambiguous are respondents' allegations that Notebaert knew about and participated in some form of

"channel stuffing," which respondents claim create a strong inference that Notebaert knew that Tellabs' fourth quarter of 2000 financial statements were falsely inflated. The Complaint defines "channel stuffing" to include both innocent conduct (such as offering discounts and extended payment terms) and culpable conduct (such as shipping unordered products to customers). Yet the Complaint strategically avoids alleging which type of "channel stuffing" Notebaert knew about. Here again, the Complaint alleges only facts that are as consistent with innocent conduct as with culpable conduct.

The bare allegation that Notebaert knew of "problems" with the TITAN 6500 is also far too ambiguous to support a "strong" inference of scienter. Neither is the strong inference standard satisfied by the general allegation that Notebaert, like other executives at the Company, was kept apprised generally of the Company's business. Such allegations not only fail specifically to tie Notebaert's knowledge to details about the TITAN 6500, but they are also the kind of facts that are as likely to be true in cases of innocence as culpability. Executives are *always* kept regularly apprised of the company's overall financial condition. Such a generally true allegation cannot support a strong inference of fraudulent intent.

Finally, respondents allege no facts that suggest why Notebaert would have suddenly commenced a fraud in December 2000, and then, just as suddenly, stopped seven months later. Neither Notebaert nor the Company is alleged to have received any economic benefit at all in the interim from this temporally circumscribed fraud. The absence of any reason for Notebaert to have engaged in fraud places an especially heavy burden on respondents to produce allegations that directly and strongly suggest Notebaert knew he was misleading the public. Respondents did not even come close to meeting their burden.

ARGUMENT

I. THE REFORM ACT REPLACES THE NOTICE PLEADING REGIME OF THE FEDERAL RULES WITH A REQUIREMENT THAT THE PLAINTIFF PLEAD FACTS THAT DEMONSTRATE A SUBSTANTIAL CLAIM AS TO A DEFENDANT'S SCIENTER.

A. The Federal Rules' Notice Pleading Approach.

The 1938 promulgation of the Federal Rules of Civil Procedure greatly simplified the task of pleading, which was so complicated at common law and under the codes that it was "virtually impossible logically to distinguish" between proper and improper pleading. J.B. Weinstein & D.H. Distler, *Comments on Procedural Reform: Drafting Pleading Rules*, 57 Colum. L. Rev. 518, 520-21 (1957); see generally C.E. Clark, *Simplified Pleading*, 2 F.R.D. 456, 458-64 (1943) (discussing historical evolution of pleading and simplifications brought about by the federal rules); compare, *e.g.*, W.W. Cox, *Statements of Fact in Pleading under the Codes*, 21 Colum. L. Rev. 416, 417-22 (1921) (describing some of the potential pitfalls of pleading prior to the federal rules). While older pleading rules sought, among other things, to "narrow[] the issues that must be litigated" and "provid[e] a means for speedy disposition of sham claims and insubstantial defenses," the technical requirements that grew up around those rules often led to cases being dismissed "without regard to the merits of the controversy." 5 C. Wright & A. Miller, *Federal Practice and Procedure: Civil* § 1202, at 88 (3d ed. 2004).

Modern pleading rules have struck a different balance. A modern complaint is designed merely to put the defendant on notice of the subject matter of the claim, and allow the litigation to proceed to a decision on the merits. "[T]he Federal Rules of Civil Procedure do not require a claimant to set out in detail the facts upon which he bases his claim. To

the contrary, all the Rules require is 'a short and plain statement of the claim' that will give the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests." *Conley* v. *Gibson*, 355 U.S. 41, 47 (1957) (footnote omitted).

The notice-pleading regime allows claims to proceed based on a "'reasonably founded hope that the [discovery] process will reveal relevant evidence'" to support the claim. *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336, 347 (2005) (alteration in original) (quoting *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 741 (1975)). This lax standard for pleading provides plaintiffs "an incentive to plead vaguely in hopes that discovery will turn up material on which to base a more specific charge." R. Marcus, *The Revival of Fact Pleading under the Federal Rules of Civil Procedure*, 86 Colum. L. Rev. 433, 445-46 (1986). The pleading rules expect that some cases may be filed without the plaintiff knowing much of the details that may ultimately be relied upon to establish liability. *Swierkiewicz* v. *Sorema N.A.*, 534 U.S. 506, 511-12 (2002) (Rule 8 does not require a plaintiff in an employment discrimination case to plead facts establishing a *prima facie* case because discovery might later uncover direct evidence of discrimination that would support the claim on the merits).

The generally applicable notice pleading standard was purposefully set low in light of the overall structure of the Rules. The "simplified notice pleading standard relies on liberal discovery rules and summary judgment motions to define disputed facts and issues and to dispose of unmeritorious claims." *Swierkeiwicz*, 534 U.S. at 512; *Celotex Corp.* v. *Catrett*, 477 U.S. 317, 327 (1986). As a result, on a motion to dismiss in a typical case, the "issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims. Indeed it may appear on the face of the pleadings that a recovery is very remote and unlikely but that is not the test." *Scheuer* v. *Rhodes*, 416 U.S. 232, 236 (1974).

Rule 9(b) states that a greater degree of factual specificity is required with respect to the "circumstances constituting fraud." This requirement is a deviation from the general rule. See *Leatherman* v. *Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 168 (1993).[10] But the paradigm of notice pleading is specifically preserved on the face of Rule 9(b) as to allegations of "[m]alice, intent, knowledge, and other condition of mind." Such allegations, according to the terms of the Rule, "may be averred generally." Fed. R. Civ. P. 9(b).

Shortly prior to passage of the Reform Act, this Court suggested in *Leatherman* that Rule 9(b) should be read literally, and that its particularity requirement should be limited to the matters specifically identified as subject to it. 507 U.S. at 168; see *Jones* v. *Bock*, No. 05-7058, slip op. at 12 (U.S. Jan. 22, 2007) ("'Specific pleading requirements are ... not [mandated], as a general rule, through case-by-case determinations of the federal courts.'") (quoting *Hill* v. *McDonough*, 126 S. Ct. 2096, 2103 (2006)).[11] As the Ninth Circuit observed, *Leatherman* called into question efforts developed by other courts, discussed below, *infra* at 31-33, to require securities fraud plaintiffs to plead specific facts giving rise to a strong inference of scienter. *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541 (9th Cir. 1994) (en banc). The Ninth

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[10] At common law and under the codes, "a higher degree of certainty and more specific details were required in the declaration in actions which were disfavored because of their nature, or in which the defendant's morality was brought in question." C.E. Clark, *Handbook of the Law of Code Pleading* § 48, at 311-12 (2d ed. 1947)).

[11] Whether in certain cases the underlying substantive law at issue might, as a matter of judicial interpretation and application of Rule 8, affect the level of factual detail required in a pleading is under this Court's consideration in *Bell Atlantic* v. *Twombly*, No. 05-1126 (U.S. argued Nov. 27, 2006). That issue is not directly presented here because Congress has specifically addressed itself to the pleading standard for securities fraud cases, as discussed below.

Circuit reasoned that while those efforts may be based in sound policy considerations regarding the need to deter and defeat the too-frequent practice of securities fraud strike suits, "[w]e are not permitted to add new requirements to Rule 9(b) simply because we like the effects of doing so. This is a job for Congress, or for the various legislative, judicial, and advisory bodies involved in the process of amending the Federal Rules." *Id.* at 1546. On this view, the failure to plead specific facts to support allegations of scienter would not prevent a securities fraud claim from following the path that the Federal Rules contemplated for most cases: quickly past the pleadings and on to discovery for ultimate consideration on the merits.

B. The Language, Structure And Legislative History Of The Reform Act Make Clear That Congress Displaced The Federal Rules' Approach To Pleading And Required Specific Facts That Demonstrate A Substantially Meritorious Claim As To Scienter.

In the Reform Act, Congress provided the specific authority for the aggressive review of securities fraud complaints, and especially scienter allegations, that the Ninth Circuit in *GlenFed* believed had been lacking.[12] The Reform Act establishes standards and procedures that require a review of the pleadings focusing on far more than the adequacy of notice. A court is required to consider whether the facts alleged in the complaint strongly show the promise or substantial merit in a plaintiff's claim of scienter. The court thus reviews the complaint with an eye on the plaintiff's ultimate prospects for success based on what facts the plaintiff can allege *prior* to discovery. Such review

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[12] When passing the Reform Act, Congress was aware that "the courts of appeals [had] interpreted Rule 9(b)'s requirement in conflicting ways, creating distinctly different standards among the circuits." H.R. Conf. Rep. No. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740.

necessarily involves consideration not only of the facts the plaintiff suggests support an inference of scienter, but of all the facts alleged in the complaint as a whole, along with all other facts properly considered at the pleading stage.

The legislative history explains why Congress chose to break from the ordinary procedure of delaying any consideration of the claim's prospects for success until *after* the plaintiff has access to discovery. A substantial premise of the notice pleading approach, that summary judgment proceedings can quickly dispose of weak claims after the pleadings, had proved false in securities fraud cases. Defendants were being forced by the economic realities of securities litigation to settle even meritless claims that proceeded beyond the pleadings. Congress's response to the troubling frequency of strike suits in securities litigation built and expanded upon concerns expressed by courts that had identified the seriousness of the problem prior to the Reform Act.

1. The Reform Act strikingly places great emphasis on the pleading of specific facts in support of a securities fraud claim. "[E]ach statement alleged to have been misleading" must be specified. 15 U.S.C. § 78u-4(b)(1). In addition, "the reason or reasons why the statement is misleading" must also be specified. *Id.* And when allegations are made on information and belief regarding the allegedly misleading statements, "the complaint shall state with particularity *all* facts on which that belief is formed." *Id.* (emphasis added).

The text quickly makes clear that part of the reason for requiring such factual specificity with respect to the allegedly misleading statements is to facilitate judicial scrutiny of the allegations of scienter. The "complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts" supporting the allegation of scienter. *Id.* § 78u-4(b)(2). The particularity requirement as to facts supporting an inference of scienter squarely rejects permitting

scienter to be averred generally, as a literal reading of Rule 9(b) would require.

Most importantly, Congress went beyond requiring the pleading of particularized facts with respect to scienter. Congress chose to specify that the pleading must state particularized "facts giving rise to a *strong* inference" of scienter. *Id.* (emphasis added). The requirement of a "strong inference" of scienter is the clearest textual evidence of the break from a notice pleading regime in the Reform Act. The notion of requiring a pleading to make a "strong" case, or even to present allegations that "strongly" support an element of a claim, is entirely foreign to notice pleading. The adjective "strong" has nothing to do with identifying the issues in dispute. If Congress wanted the complaint merely to identify issues to open the door to discovery, then it could have required specific facts giving rise to "an inference" of scienter. Instead, it chose to require a "strong inference," which in this context means "compelling" or "capable of making a clear or deep impression esp[ecially] on the mind." *Webster's Third New International Dictionary of the English Language Unabridged* 2265 (1993). The word is one of force and effectiveness, not notice. *The American Heritage Dictionary* 1369 (2004) (defining "strong" as "persuasive, effective, and cogent").

Taken together, the emphasis on particularity in pleading and the "strong inference" requirement with respect to scienter put a heavy burden on a securities fraud pleader. The complaint must do more than tell the defendant at a high level of specificity what facts are likely to be the focus of the dispute. The Reform Act requires the complaint to paint a detailed picture of the facts that meaningfully tends to exclude the possibility of innocence and cogently shows that

the plaintiff's claim that the defendant acted with scienter has substantial merit.[13]

The procedure the Reform Act establishes supports interpreting the "strong inference" standard to require a substantially meritorious case before access to discovery. The Reform Act insists that the plaintiff marshal factual allegations without access to discovery. Discovery often proceeds during the pendency of a motion to dismiss in other litigation. See 8 C. Wright et al., *Federal Practice and Procedure* § 2008 (2d ed. 2006) ("Discovery is not to be denied because it relates to a claim or defense that is being challenged as insufficient."). Under the Reform Act, however, discovery is, as a general rule, stayed during the pendency of the motion to dismiss. 15 U.S.C. § 78u-4(b)(3)(B). The Reform Act is so opposed to a plaintiff using discovery to ferret out support for a complaint that it even provides for an order staying discovery in related *state* court cases. *Id.* § 78u-4(b)(3)(D).

2. The legislative history of the Reform Act fully supports what the text and structure of the Act reveal. Congress decided to change the litigation process in a way that deterred the filing of "roll-the-dice," speculative securities fraud suits, and equipped courts and defendants with further mechanisms to dismiss such suits before the costly discovery process began.

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[13] As discussed more fully below, *infra* at 30-31, this standard functions similarly to this Court's antitrust decisions, which require a plaintiff to "present evidence 'that tends to exclude the possibility'" that the defendants acted innocently. *Matsushita Elec. Indus. Co.* v. *Zenith Radio Corp.*, 475 U.S. 574, 588 (1986) (quoting *Monsanto Co.* v. *Spray-Rite Serv. Corp.*, 465 U.S. 752, 764 (1984)). In addition, and as discussed more fully below, this standard was also adopted for reasons similar to this Court's rationale for interpreting "antitrust law [to] limit[] the range of permissible inferences" that would warrant further litigation. *Matsushita*, 475 U.S. at 588.

Congress passed the Reform Act and strengthened the pleading requirements for scienter because it found that Rule 9(b) had "not prevented abuse of the securities laws by private litigants." H.R. Conf. Rep. No. 104-369, at 41 (1995) ("H.R. Rep."), *reprinted in* 1995 U.S.C.C.A.N. 730, 740; see *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Dabit*, 126 S. Ct. 1503, 1510-11 (2006) (explaining that Congressional policy behind the Reform Act was to defeat abusive litigation practices). Congress had found that "[a] complaint alleging violations of the Federal securities laws is easy to craft and can be filed with little or no due diligence." S. Rep. No. 104-98 (1995), at 8 ("S. Rep."), *reprinted in* 1995 U.S.C.C.A.N. 679, 687. Congress was aware of the "the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action." H.R. Rep. at 31, *reprinted in* 1995 U.S.C.C.A.N. at 730.

Securities fraud suits are particularly subject to meritless strike suits. See generally, Amicus Br. of SIFMA & Chamber of Commerce 6-9. The cost to the defendant of litigating greatly exceeds the cost to the plaintiff. Corporate defendants not only must pay for attorneys, but also must consider the "disruption of normal business activities," *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 743 (1975), that is occasioned by complying with typically massive document requests and time lost for depositions. W. Baskin, Note, *Using Rule 9(b) to Reduce Nuisance Securities Litigation*, 99 Yale L.J. 1591, 1596-97 (1990) (discussing differential in incentives to continue in litigation rather than settle between defendants and plaintiffs in securities cases); H.R. Rep. at 37, *reprinted in* 1995 U.S.C.C.A.N. at 736 ("[T]he threat that the time of key employees will be spent responding to discovery requests, including providing deposition testimony, often forces coercive settlements."). In addition, many cases

involve potentially crippling claims against the company, especially if, as is often the case, the suit was precipitated by a substantial drop in stock price. The inherent uncertainties of litigation create powerful incentives for companies to settle rather than defend a bet-the-company suit. Settlement in such circumstances is often driven by factors far removed from the merits. S. Rep. at 7, *reprinted in* 1995 U.S.C.C.A.N. at 686 ("If a defendant cannot win an early dismissal of the case, 'the economics of litigation may dictate a settlement even if the defendant is relatively confident that it would prevail at trial.'") (quoting the testimony of SEC Chairman Arthur Levitt); J. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 501 (1991) (finding that the merits do not affect settlement outcomes in securities fraud lawsuits).

The litigation process in securities fraud cases had been transformed from a means for resolving disputes to an incentive for plaintiffs' counsel to create disputes where none ought to exist. As this Court observed,

> in the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment.

Blue Chip Stamps, 421 U.S. at 740.

The litigation process was thus undermining the policies of securities regulation. One of the principal policies of the securities laws is to encourage disclosure of information regarding publicly traded companies. *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963). "Abusive litigation severely affects the willingness of corporate managers to disclose information to the marketplace." H.R. Rep. at 42, *reprinted in* 1995 U.S.C.C.A.N. at 741. Private

securities class actions, however, "inhibit free and open communication among management, analysts, and investors." S. Rep. at 5, *reprinted in* 1995 U.S.C.C.A.N. at 684. Public companies fear that releasing information makes them vulnerable to attack. "As a result, investors often receive less, not more, information, which makes investing more risky and increases the cost of raising capital." *Id.* As this Court succinctly observed, Congress's motivation behind the Reform Act was to defeat abusive litigation practices that "resulted in extortionate settlements, chilled any discussion of issuers' future prospects, and deterred qualified individuals from serving on boards of directors." *Dabit*, 126 S. Ct. at 1510-11.[14]

Because the private litigation process itself was undermining the goals of the securities laws, Congress fundamentally changed that process. Significantly, Congress applied the "strong inference" standard only to *private* suits brought under the 1934 Act. 15 U.S.C. § 78u-4(b)(2). The pre-Reform Act pleading standard thus remains unchanged for suits brought by the SEC. This result reflects Congress's considered view that the typical private securities fraud suit was no longer serving the public interest in the way that suits brought by the SEC do. Amicus Br. of SIFMA & Chamber of Commerce 17-19 (discussing SEC willingness and ability to enforce securities laws).

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[14] It was also clear that the securities litigation regime then in place was causing capital to flee from the United States. H.R. Rep. No. 104-50, at 20 (1995) ("Fear of litigation keeps companies out of the capital markets."). As a recent report by the independent, bipartisan Committee on Capital Markets Regulation found, "the United States is losing its leading competitive position as compared to stock markets and financial centers abroad." *Interim Report of the Committee on Capital Markets Regulation* at ix (Nov. 30, 2006), *available at* http://capmktsreg.org/research.html. "Foreign companies commonly cite the U.S. class action enforcement system as the most important reason why they do not want to list in the U.S. market." *Id.* at 11; see generally, Amicus Br. of SIFMA & Chamber of Commerce 9-12.

In strengthening the pleading requirements for stating a private securities fraud claim, Congress "sought to strike the appropriate balance between protecting the rights of victims of securities fraud and the rights of public companies to avoid costly and meritless litigation." S. Rep. at 10, *reprinted in* 1995 U.S.C.C.A.N. at 689. The pleading standard adopted in the Reform Act, which imposes substantial pre-complaint investigation costs on the plaintiff, advances Congress's goal of deterring nonmeritorious suits by increasing the costs to a plaintiff of filing a suit that has a chance of producing a settlement. By authorizing substantive review of the complaint by a court to ensure that the plaintiff has uncovered facts that, if proved, present a cogent picture of a claim with significant merit, Congress instructed that strike suits lacking significant merit be dismissed before they could cause substantial harm.

The "strong inference" standard bears resemblance to the approach this Court has taken in reviewing claims under the antitrust laws. This Court has itself recognized that, in antitrust cases, courts should apply procedural rules in a way that protects against the potential of litigation itself to undermine the public policies advanced by the underlying substantive law. In *Matsushita Electrical Industrial Co.* v. *Zenith Radio Corp.*, this Court precluded a trial in a price fixing conspiracy case, recognizing that "*mistaken* inferences in cases such as this one are especially costly, because they chill the very conduct the antitrust laws are designed to protect." 475 U.S. 574, 594 (1986) (emphasis added). In light of the fact that litigation based on evidence supporting only weak inferences of anticompetitive conduct threatened to deter procompetitive behavior, this Court applied the summary judgment standard in a way that balanced the need to protect against harmful mistaken inferences with "the desire that illegal conspiracies be identified and punished." *Id.* It did so as a matter of law by narrowing the range of permissible inferences that might be drawn from facts in such

cases. See also *Monsanto Co.* v. *Spray-Rite Serv. Corp.*, 465 U.S. 752, 762-64 (1984).

The fact that in the Reform Act Congress chose to narrow the range of permissible inferences *at the pleading stage* does not make *Matsushita* and *Monsanto*, which are summary judgment decisions, any less instructive. Both this Court's antitrust decisions and the Reform Act's "strong inference" standard are a response to the need to narrow the range of permissible inferences to protect the underlying policies of the relevant substantive federal law (antitrust and the securities laws, respectively) from harms caused by further litigation. As discussed above, Congress chose not to wait for the summary judgment stage to narrow the range of permissible inferences in securities cases because it determined that the litigation process was undermining the policies of the securities laws by too often forcing defendants to settle meritless claims long before the summary judgment stage. In the end, Congress has followed this Court's direction in *Leatherman*, 507 U.S. at 168, to provide express statutory authority for special pleading standards when it concludes that public policy warrants exempting a specific cause of action from the generally applicable rules.

3. By requiring a securities fraud complaint to paint a cogent picture of a substantially meritorious claim as to scienter, Congress was codifying, strengthening, and making uniform a procedure that certain courts of appeals had already begun to develop. Numerous courts had concluded prior to the Reform Act that a federal securities fraud complaint needed to allege specific facts that would support an inference of scienter. *E.g.*, *Ross* v. *A.H. Robins Co.*, 607 F.2d 545, 558 (2d Cir. 1979) (affirming dismissal where plaintiffs did not allege a "strong inference" that the defendants had knowledge of undisclosed facts); *Greenstone* v. *Cambex Corp.*, 975 F.2d 22, 25-27 (1st Cir. 1992) (Breyer, J.) (a securities fraud complaint must "set forth specific facts that make it reasonable to believe that [the] defendant knew that [the]

statement was materially false or misleading"); *DiLeo* v. *Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (affirming dismissal where "the complaint offers no reason to infer that [the defendant] possessed the mental state necessary for a primary violation [of Section 10(b)]"); *Tuchman* v. *DSC Communications Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994) ("To plead scienter adequately, a plaintiff must set forth specific facts that support an inference of fraud."). The Second Circuit specifically required that the inference of scienter drawn from the allegations had to be "strong," *Ross*, 607 F.2d at 558, whereas other courts required facts that created a "reasonable" inference of scienter, *Greenstone*, 975 F.2d at 25, or merely "an inference" of scienter, *Tuchman*, 14 F.3d at 1068.

These courts recognized this requirement as an extension of the traditional rationale behind requiring particularity with respect to the circumstances constituting fraud: the need to safeguard a defendant's reputation or goodwill from improvident charges of wrongdoing. *Shields* v. *Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994). But these courts were also using the complaint to evaluate the prospects of success in securities fraud claims. *DiLeo*, 901 F.2d at 629 (stating that in order to survive a motion to dismiss, a securities fraud complaint "must afford a basis for believing that plaintiffs could prove scienter"); *Greenstone*, 975 F.2d at 27 (affirming dismissal of complaint for failure to plead scienter because the facts in support of an inference of scienter were "not strong enough to bear the great overarching weight ... the plaintiff wishes [them] to support" and because the "inferential links are weak"); M. Louis, *Interpreting and Discouraging Doubtful Litigation*, 67 N.C. L. Rev. 1023, 1040 n.118 (1989) (stating that judges requiring specific facts supporting inference of scienter were seeking a "demonstration that the plaintiff has a bona fide, provable claim"); Note, *Pleading Securities Fraud with Particularity Under Rule 9(b)*, 97 Harv. L. Rev. 1432, 1442 & n.52 (1984)

(stating that dismissals for failure to satisfy Rule 9(b) "require the judge to make at least a preliminary judgment on the merits of the complaint").

This focus on whether a securities fraud complaint showed promise for success on the merits was driven, even prior to the Reform Act, by a recognition that securities fraud claims were particularly subject to strike suits, and that meritless litigation in this context undermined the very policies that the securities laws sought to advance. *E.g.*, *Ross*, 607 F.2d at 557; *Shields*, 25 F.3d at 1128; *Tuchman*, 14 F.3d at 1067; *Wayne Inv., Inc.* v. *Gulf Oil Corp.*, 739 F.2d 11, 13 (1st Cir. 1984). Courts perceived that the rules generally favoring notice, and litigation on the merits beyond the pleadings, had to be tempered by the concern against allowing "the use of the litigation process as a device for extracting undeserved settlements as the price of avoiding the extensive discovery costs that frequently ensue once a complaint survives dismissal." *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 263 (2d Cir. 1993). These courts believed it was their responsibility to work out a rough balance between these competing interests on a case-by-case basis, in light of the absence of a clear standard in the securities statutes or procedural rules. *Id.* at 264. In the Reform Act, Congress has both endorsed that effort and provided substantive direction for how to carry out the task: Congress has chosen to give access to compulsory discovery only to plaintiffs whose factual allegations demonstrate strong promise on the merits while keeping weakly grounded claims out of court.

C. The Text And Purpose Of The Reform Act Reveal Principles For Evaluating Whether A Complaint Alleges Facts Creating A Strong Inference Of Scienter.

The change in orientation to the adequacy of a complaint under the Reform Act is important. But at least as important are the readily applicable principles for evaluating certain common categories of allegations that emerge from the text

and purpose of the Reform Act. Whatever verbal formulation this Court ultimately adopts as the interpretation of the "strong inference" standard,[15] it should encompass the following principles which, even before passage of the Reform Act, courts had already begun to articulate as part of a judicial effort to advance the policies that later motivated Congress to pass the Act.

The first principle concerns evaluating allegations not in isolation but in the overall context created by the complaint. The second principle concerns the presence or *absence* of allegations of the defendant's motive to engage in fraud, which plays an important role in determining whether it makes sense to infer that the defendant acted unlawfully. And a third set of principles concerns the problems posed by

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[15] Petitioners have argued above that a complaint states particular facts giving rise to a "strong inference" of scienter when the facts cogently demonstrate a promising and substantial claim on the merits that meaningfully tends to exclude alternative innocent explanations. Certain courts of appeals have expressed a similar concept with somewhat different language. *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2005) (stating that even though the "inference need not be ironclad, it must be persuasive"); *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 897 (9th Cir. 2002) (stating complaint should be dismissed if innocent inference "is equally if not more plausible" than culpable inference); *Ottman* v. *Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 348-50 (4th Cir. 2003) (same). The Sixth Circuit has used language that might be read to suggest an even higher burden than that suggested by petitioners. *Helwig* v. *Vencor*, 251 F.3d 540, 553 (6th Cir. 2001) (en banc) (requiring facts that "leave little room for doubt as to misconduct" and allowing complaint to survive only if the inference of scienter is "the most plausible of competing inferences"). As a practical matter, these various verbal formulae all lead to the same outcome in this case because the same set of dispositive principles with respect to inadequate allegations, discussed below, emerge from them all. And all of these formulations of the standard, including that of petitioners, remain true to the text and purpose of the Reform Act, unlike the Seventh Circuit's standard, Pet. App. 20a, which differs little from traditional pleading rules.

ambiguities in pleadings. Those principles, when applied to the Complaint here, require its dismissal.

1. A court reviewing a complaint to determine whether it alleges facts creating a "strong inference" of scienter should take into consideration all the facts and allegations that bear on the question, not just those facts or inferences that might be viewed as favoring the plaintiff's charge. As discussed above, the Reform Act requires a court to consider whether a complaint, assuming the truth of plaintiff's allegations, demonstrates promise for ultimately establishing scienter. A claim's substantial merit can be gauged only in light of the entirety of what is before the court. *Matsushita*, 475 U.S. at 587. Further, to look only at those allegations the plaintiff asserts support the inference of scienter, without paying heed to contrary inferences arising from other facts before the court, is to read the "strong" inference requirement out of the statute. *Pirraglia* v. *Novell, Inc.*, 339 F.3d 1182, 1187 (10th Cir. 2003); *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 897 (9th Cir. 2002); *Helwig* v. *Vencor*, 251 F.3d 540, 553 (6th Cir. 2001) (en banc). The "strength" of facts or allegations can be known only in light of the *overall* context and their relation to other, potentially countervailing or explanatory facts. *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 52 (1st Cir. 2005); *Pirraglia*, 339 F.3d at 1187; *Gompper*, 298 F.3d at 897; *Greenstone*, 975 F.2d at 25. If the Reform Act is to achieve its purpose of deterring and defeating inadequately grounded claims, then courts must look at everything, taken together, to determine whether an assertion of scienter is weak and speculative (and should be dismissed) or well-grounded and strong (and permitted to proceed).

This balanced approach means that if the defendant engages in conduct that is directly at odds with the putative purpose of the alleged fraud, the inference of scienter is correspondingly weakened. For example, a defendant, as here, who is alleged to have fraudulently inflated the company's stock price by misleading investors into believing that demand was strong

would not be expected to announce *in the midst of the alleged fraud* that demand is weakening and that revenue projections are being lowered. See *infra* at 47-48. The "strength" of the inference of scienter with respect to such an alleged fraud simply cannot be determined without taking into account how the inference is severely undermined in light of this conduct.

2. The presence or absence of allegations of a defendant's motive to engage in fraud should also play a role in evaluating the strength of the inference of scienter.[16] Courts, both before and after the Reform Act, *Tuchman*, 14 F.3d at 1068; *DiLeo*, 901 F.2d at 629; *Migliaccio* v. *K-Tel Int'l, Inc.* (*In Re K-Tel Int'l, Inc. Sec. Litig.*), 300 F.3d 881, 894 (8th Cir. 2002); *Florida State Bd. of Admin.* v. *Green Tree Fin. Corp.*, 270 F.3d 645, 660 (8th Cir. 2001); *Kalnit* v. *Eichler*, 264 F.3d 131, 142 (2d Cir. 2001), have noted that the absence of allegations as to a plausible motive imposes a heavy burden on the plaintiff to present compelling direct allegations of scienter. This requirement makes sense because the absence of allegations of motive means that a court is being asked to infer that the defendant engaged in wrongdoing "for the sheer joy of it, rather than for profit."

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[16] The courts of appeals have split over whether allegations of motive and opportunity may, independently of other allegations, give rise to a "strong inference" of scienter. *Compare Kalnit* v. *Eichler*, 264 F.3d 131, 139 (2d Cir. 2001), *and In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-535 (3d Cir. 1999), *with Goldstein* v. *MCI Worldcom*, 340 F.3d 238, 246 (5th Cir. 2003), *and City of Phila.* v. *Fleming Cos.*, 264 F.3d 1245, 1249 (10th Cir. 2001), *and Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 197 (1st Cir. 1999), *and Hoffman* v. *Comshare, Inc.* (*In re Comshare Inc. Sec. Litig.*), 183 F.3d 542, 549 (6th Cir. 1999). As discussed below, there are no allegations in this case that any court would recognize as establishing motive, *infra* at 49-50, so this case does not squarely present the question. Nonetheless, for the reasons stated in the previous paragraph, petitioners agree with the majority of circuits that have concluded that motive and opportunity allegations should be considered together with all the allegations and materials before the court to determine whether the allegations, taken as a whole, give rise to a "strong inference" of scienter.

SEC v. *Steadman*, 967 F.2d 636, 642 (D.C. Cir. 1992); *DiLeo*, 901 F.2d at 629.

In antitrust cases, this Court has noted that "the absence of any plausible motive to engage in the conduct charged is highly relevant" to whether the case should continue to trial. *Matsushita*, 475 U.S. at 596. "Lack of motive bears on the range of permissible conclusions that might be drawn from ambiguous evidence." *Id.*; *First Nat'l Bank of Ariz.* v. *Cities Serv. Co.*, 391 U.S. 253, 285-87 (1968) (considering absence of motive of defendant to join conspiracy as bearing on whether other facts are "sufficiently probative" to warrant trial). The absence of motive undermines the strength of other allegations that do not clearly support an inference of scienter.

3. Allegations that are as consistent with innocence as they are with culpability do not satisfy the "strong inference" standard. Indeed, it is difficult to understand how an inference of scienter can be considered "strong" if even on the face of the complaint, and even assuming all well-pleaded facts as true, the claimed culpable inference appears no more plausible than alternative, innocent inferences. Once again, this principle emerges from cases both before and after the Reform Act. *Greenstone*, 975 F.2d at 26; *Mills* v. *Polar Molecular Corp.*, 12 F.3d 1170, 1176 (2d Cir. 1993); *Garfield* v. *NDC Health Corp.*, 466 F.3d 1255, 1265 (11th Cir. 2006); *Credit Suisse*, 431 F.3d at 49; *Ottman* v. *Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 350 (4th Cir. 2003); *Gompper*, 298 F.3d at 896; *Helwig*, 251 F.3d at 553. It also derives from the core purpose of the Reform Act, which is to prevent speculative claims from proceeding into discovery, where the pressures to settle independent of the merits are overwhelming. A plaintiff that is able to put forth allegations that are merely consistent with culpability to the same extent they are consistent with innocence has done nothing more than raise the possibility of liability. Congress has chosen not to open the doors of litigation to claims so weakly grounded because doing so will, over the run of cases, undermine the

policies of the securities laws more than it will advance them. *Supra* at 27-30.

Once again, this Court's decisions from the antitrust context are instructive. In that context, this Court has said that "conduct that is as consistent with permissible competition as with illegal conspiracy does not, without more, support even an inference of conspiracy." *Matsushita*, 475 U.S. at 597 n.21; *Monsanto*, 465 U.S. at 763-64. Instead, "[t]he evidence must 'tend to exclude the possibility'" of legitimate conduct. *Matsushita*, 475 U.S. at 597 (alteration omitted). Ambiguous allegations or facts are not permitted to support an antitrust judgment because the effect would often be to punish legitimate competition, which is precisely what the antitrust laws are supposed to encourage. *Id.* at 594. Subjecting such an ambiguous claim to further litigation would, therefore, undermine the purpose of the underlying substantive law. Congress has reached a similar conclusion with respect to ambiguous allegations and allowing access to the litigation process in securities cases.

There are at least two different categories of pleading ambiguities that are relevant here and have been discussed in the cases, neither of which should be understood to give rise to a "strong inference" of scienter. One sort of ambiguity, which might be called strategic ambiguity, leaves out details that would clarify whether the identified conduct was either innocent or culpable. It is critical that a complaint include such details if the Reform Act is to perform its purpose of deterring and defeating speculative claims. It was Congress's intent to prevent those pleaders who are unwilling or unable to allege[17] detail sufficient to distinguish culpable from innocent conduct from imposing the costs of litigation on the

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[17] An allegation is not itself proof, but it may be put forth after the plaintiff determines that he has some "evidentiary support" for the assertion. Fed. R. Civ. P. 11(b)(3).

defendants, the courts and ultimately the capital markets and U.S. economy.

Hostility to strategically ambiguous pleading is well rooted in our legal tradition. The common law penalized ambiguous pleaders. *United States* v. *Linn*, 42 U.S. 104 (1843), involved an action against several defendants who were parties to a debt instrument. One of the defendants pleaded that after he signed his name to the debt instrument, it was altered without his consent by affixing seals to his signature. *Id.* at 110. The pleading did not state whether the alteration was made without the knowledge or consent of the plaintiff, in which case the alteration would not have affected the defendant's liability. *Id.* This Court held that in such a circumstance, the pleading "is to be construed most strongly against" the pleader. *Id.* "[T]he reason assigned for this rule of construction, is, that it is a natural presumption, that the party pleading will state his case as favourably as he can for himself. And if he does not state it with all its legal circumstances, the case is not favourable to him ...." *Id.* at 110-11.

This Court again emphasized this rule of pleading in *Stuart* v. *United States*, 85 U.S. 84 (1873). There, plaintiffs sought recovery under a statute authorizing reimbursement to government contractors whose property had been destroyed "by an enemy" when the property at issue was in the military service of the United States. This Court affirmed dismissal of the petition as insufficiently pleaded where it was alleged that the property was destroyed by "'a band of hostile Indians.'" *Id.* at 87. The Court observed that plaintiffs failed to plead "to whom or to what these Indians were hostile," stating, "[t]hey may have been hostile to the government of the United States, they may have been hostile, inimical, or unfriendly to the owners of the cattle only." *Id.* at 87-88. Because the pleader had failed to state whether the Indians were hostile to the United States, "[t]he law assumes that these deficiencies in it

exist because the petitioner could not with advantage to his case supply them." *Id.* at 88.

As *Linn* and *Stuart* demonstrate, the common law required the pleader to allege his case as strongly as he could, and inferred a weak case from ambiguity. The mere possibility that facts uncovered later would clarify the ambiguity and support the pleader was insufficient to allow the claim to survive. Likewise, in the Reform Act, Congress has chosen to insist that the plaintiff plead the case as favorably as he can. Courts should infer a weak case (and dismiss the complaint) if the plaintiff can produce facts that do no more than raise a mere possibility of liability arising from ambiguity.[18]

Another kind of ambiguity concerns conduct or circumstances that are just as likely to be associated with innocence as wrongdoing. Such ambiguous allegations have been asserted with respect to a wide range of alleged conduct, including, for example, knowledge based on mere access to documents (as opposed to actually reviewing them) by virtue of a defendant's status as an executive of the company, or motive to engage in fraud merely by virtue of a standard incentive compensation plan, or ordinary trading activity.

Once again, both before and after the Reform Act, *Acito* v. *IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995); *Shields*, 25 F.3d at 1130; *Tuchman*, 14 F.3d at 1068-69; *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1424 (3d Cir. 1997) (Alito, J.) (decided under pre-Reform Act law); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 539 (3d Cir. 1999); *Ottman*, 353 F.3d at 352; *Green Tree*, 270 F.3d at 655, courts have held that such allegations do not support an

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[18] Even today the federal pattern jury instruction for fraud states, "If a transaction that is called into question is equally capable of two interpretations, one honest and the other fraudulent, it should be found to be honest." 3 *Federal Jury Practice & Instructions* § 123.10 (5th ed. 2007).

inference that the defendant possessed fraudulent intent.[19] And once again, the purpose of the Reform Act makes clear that these courts are correct. If ordinary conduct itself created a "strong inference" of scienter, then nearly every case would satisfy the "strong inference" standard. See *Monsanto*, 465 U.S. at 762-63 (an antitrust plaintiff may not survive summary judgment by presenting evidence that a "manufacturer and its distributors are in constant communication about prices" because they "have legitimate reasons to exchange information about the prices and the reception of their products in the market"; same for evidence that manufacturer received complaints from distributor about "price-cutters" because such complaints "arise in the normal course of business"). The Reform Act's substantive pleading requirement would become nothing more than an empty command to invoke certain magic words in a pleading if commonly occurring, ambiguous conduct sufficed to create a "strong inference" of scienter. Strike suits would not be reduced; they would become formulaic.

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As discussed more fully below, the Seventh Circuit did not apply the pleading principles discussed above to the allegations of the Complaint. To the contrary, the Seventh Circuit chose to give the respondents the benefit of the doubt created by their ambiguous allegations, and refused to place the allegations in their full context. The Seventh Circuit expressly shied away from interpreting the "strong inference" standard as imposing a rigorous pleading requirement because

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[19] The Second Circuit has, for example, catalogued certain impermissible allegations of "motives possessed by virtually all corporate insiders." *Novak* v. *Kasaks*, 216 F.3d 300, 307-08 (2d Cir. 2000) (listing "the desire to maintain a high corporate credit rating, or otherwise sustain 'the appearance of corporate profitability, or of the success of an investment,' and ... the desire to maintain a high stock price in order to increase executive compensation, or prolong the benefits of holding corporate office") (citations omitted).

of an unexplained concern about the Seventh Amendment. Pet. App. 20a. In fact, no court has *ever* offered a substantial analysis of a Seventh Amendment objection to the Reform Act, and respondents have not raised a Seventh Amendment challenge to the "strong inference" standard at any stage of these proceedings. That is because there is no basis for such concerns.

First, the Seventh Amendment is not implicated by the Reform Act because, like this Court's decision in *Matsushita*, the "strong inference" standard defines the range of permissible inferences that may be drawn from the facts alleged in light of the need to protect the policies of the securities laws from being undermined. If this Court may narrow the range of permissible inferences in light of the policies of the underlying substantive law without running afoul of the Seventh Amendment, as it did in *Matsushita*, 475 U.S. at 593-94, then clearly so may Congress.

Second, the Seventh Amendment protects only the common law right to a jury. See *Colgrove* v. *Battin*, 413 U.S. 149, 153-56 (1973) (explaining that the Seventh Amendment exists to preserve "the right to trial by jury in civil cases where it existed at common law"). The common law pleading rules discussed in *Linn* and *Stuart* thus further support the constitutional authority of Congress to set the heightened pleading standard it adopted in the Reform Act. The willingness of common law courts to dismiss a weak case because of ambiguous pleading fully supports the authority of Congress to mandate that courts evaluate the substantial merit of a statutory claim at the pleading stage. Indeed, at common law a case might be dismissed for failure adequately to plead the case even though a valid judgment could be entered based on the same pleading. 1 Chitty & Chitty, *A Treatise on the Parties to Actions and on Pleading* 236 (6th ed. 1836) (stating that a pleading might be "good after verdict" even though it "could not have been supported on demurrer"). What Congress has legislated in the Reform Act is no more

offensive to the jury right than were these common law pleading rules.[20] Therefore, what Congress has done cannot be said to offend the Seventh Amendment.

II. THE SECOND AMENDED COMPLAINT FAILS TO ALLEGE PARTICULAR FACTS GIVING RISE TO A STRONG INFERENCE OF SCIENTER.

To best guide lower courts in both articulating *and applying* the Reform Act's "strong inference" standard consistently in future cases, this Court should itself apply the Reform Act standard for pleading scienter and the generally applicable pleading principles discussed above to the allegations in this case. Indeed, as troubling as the legal standard articulated by the Seventh Circuit was, the way that court actually applied its standard reflects a particularly lax and pro-plaintiff approach, which flatly undermines the purposes of the Reform Act. A review of the Complaint's allegations pertaining to Notebaert in light of the proper standard and all the materials properly before the court reveals that the district court correctly dismissed the Complaint.

All of the allegations relied upon by the Seventh Circuit to support its conclusion that the facts give rise to a "strong inference" of Notebaert's scienter are, at best, ambiguous. (And Notebaert's scienter is the lynchpin for all remaining claims.) For that reason alone, the district court's dismissal of the Complaint should have been affirmed. Further, the Seventh Circuit failed to consider how the allegations related to Notebaert's scienter were weakened by the context illuminated by the record taken as a whole. The Seventh Circuit ignored the fact that the Company publicly announced that it was *reducing* its financial projections in the midst of

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[20] "[M]any procedural devices developed since 1791 ... have diminished the civil jury's historic domain have been found not to be inconsistent with the Seventh Amendment." *Parklane Hosiery Co.* v. *Shore*, 439 U.S. 322, 336 (1979).

what is alleged to be a fraud inflating those very projections. The absence of any allegations of a plausible motive is also noteworthy, especially in light of the fact that the alleged fraud is claimed to have suddenly ceased only seven months after it began, and no rational explanation for Notebaert either to have started or stopped the alleged fraud has been put forward. Taken as a whole (or even in isolation) the allegations of the Complaint fail to give rise to a "strong inference" of Notebaert's scienter.

1. The Seventh Circuit concluded that the Complaint adequately alleged facts giving rise to a "strong inference" that Notebaert knew Tellabs' financial results for the fourth quarter of 2000 were falsely inflated. The only allegations on which the Seventh Circuit relied, or could have relied, regarding the fourth quarter financial results are those related to "channel stuffing." Pet. App. 25a. But the allegations connecting Notebaert to the alleged "channel stuffing" are ambiguous, and apparently intentionally so.

The Complaint defines "channel stuffing" broadly to include legitimate conduct (such as offering customers discounts of 10% or 20%) as well as potentially illegitimate conduct (such as writing orders for products customers had not requested). JA 110, 112, ¶¶ 62-63, 69. Both the district court and the Seventh Circuit properly refused to draw any inference of scienter based on offering discounts to customers. Pet. App. 13a (Seventh Circuit relying only on claim that Tellabs provided "its downstream customers with unordered TITAN 5500s"); *id.* at 58a, 74a, (district court noting that offering customers discounts is legitimate conduct that does not support an inference of scienter). Indeed, the district court had dismissed an earlier version of the complaint, and had specifically informed respondents that offering discounts was legitimate, nonactionable conduct. *Id.* at 99a-100a. Despite the opportunity to replead after the district court identified this critical ambiguity, respondents did not narrow their definition of "channel stuffing," or

specify which "channel stuffing" conduct Notebaert was alleged to have known about. Respondents maintained their ambiguous allegations.

Particularly in light of that broad definition of "channel stuffing," the vague allegations that Notebaert "worked directly with Tellabs' sales personnel" to engage in unspecified "channel stuffing" and "unquestionably knew about the channel stuffing activity relating to the TITAN 5500," JA 111, 157, ¶¶ 67, 156, amount to nothing more than that he *may* have known of either illegitimate or legitimate conduct. As the Eleventh Circuit recently observed, "[a] general allegation that Individual Defendants promoted channel stuffing at a series of meetings does not establish scienter." *Garfield*, 466 F.3d at 1265; see *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 203 (1st Cir. 1999) (channel stuffing allegations do not give rise to a strong inference of scienter because "[u]nlike altering company documents, there may be any number of legitimate reasons for attempting to achieve sales earlier"). Having left their "channel stuffing" allegations ambiguous, it was merely "possible to surmise" that Notebaert acted with scienter, but a mere possibility is insufficient. *Garfield*, 466 F.3d at 1265.

Respondents' allegations concerning Notebaert's unspecified involvement in channel stuffing are functionally identical to those found wanting in *Linn* and *Stuart*. In *Linn*, the pleader said only that the document had been altered, but did not specify whether the plaintiff knew. *Linn*, 42 U.S. at 110. In *Stuart*, the pleader said only that the "band of Indians" was "hostile," but did not specify whether the band was hostile to the United States. *Stuart*, 84 U.S. at 87. Here, respondents say only that Notebaert knew of "channel stuffing," but do not specify that Notebaert knew of the illegitimate kind of "channel stuffing." Nothing in the Complaint "tends to exclude" the innocent possibility. *Matsushita*, 475 U.S. at 588. As a result, the allegations in the Complaint are at least as consistent with innocence as they are

with culpability. They do not, therefore, give rise to a "strong inference" of scienter.

2. The claim that Notebaert acted with scienter when allegedly falsely expressing confidence in customer demand for the TITAN 5500 fares no better.[21] In holding that the Complaint adequately alleged facts giving rise to a strong inference that Notebaert acted with fraudulent intent, the Seventh Circuit relied on allegations concerning two different sets of reports that allegedly showed that demand was weakening: the Probe Research Report and certain (unspecified) internal quarterly status reports. Pet. App. 23a. But the details regarding the timing of each of these reports are pled in a strategically ambiguous way.

In order to support an inference that Notebaert's statements regarding the TITAN 5500 were knowingly false, the Probe Research Report's conclusions had to have been delivered to Tellabs *before* Notebaert made the statements *and* Notebaert also had to have been aware of the report's conclusions before those statements were made. The Complaint, however, is deliberately ambiguous on these critical questions of timing. The Complaint vaguely alleges that the Probe Research Report "was *completed* in *or about* early 2001," JA 103, ¶ 39 (emphasis added); it does not allege when anyone at Tellabs received the report, or when, if ever, Notebaert was made aware of its conclusions. Once again, the allegations of the Complaint are as consistent with innocence (that Notebaert did not learn of the report's conclusions, if at all, until *after* the statements in question) as with culpability (that he learned of the report's conclusions before the statements). And

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[21] The Seventh Circuit discussed statements related to demand for the TITAN 5500 made in February, March and April 2001. Pet. App. 23a. But the Seventh Circuit itself had concluded that "it was not until March 2001 that the TITAN 5500's declining status was obvious," *id.* at 24a, which means that the facts alleged do not give rise to a "strong inference" of scienter as to any February statements.

nothing in the Complaint tends to exclude the innocent possibility.

Ambiguity as to timing is critically significant here for another reason. Other facts properly before the court undermine whatever weak inference of scienter respondents' ambiguous allegations may support. Indeed, the record indicates that Notebaert and Tellabs were continually processing new information regarding the Company's future prospects and quickly informing the public of changes as information became available.

It is undisputed that Tellabs' first quarter revenue *increased* by 21% over the previous year. JA 43. Still, on April 6, 2001, Tellabs began lowering its first quarter revenue projections because, as Notebaert expressly disclosed, there was an unanticipated fall-off in orders for the TITAN 5500 during the last two and a half weeks of March (which is the end of the first quarter). JA 36-37. This fact is especially significant in light of the Seventh Circuit's reliance on alleged internal marketing reports showing a weakening in demand to support the inference of scienter. Pet. App. 23a. Those marketing reports were alleged to have been produced in "March 2001," JA 104, ¶ 40, yet another strategically ambiguous date.[22] "March 2001" includes the last two and a half weeks of March, which is significant because on April 6 Notebaert publicly said that the Company began experiencing a fall-off in anticipated orders. Moreoever, less than two weeks later, on April 18, Tellabs lowered its revenue projections for full year 2001 to an amount that was $800 million less than originally forecast. This update is twice as great as the $400 million that was allegedly forecast by the internal reports

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[22] Obviously, a "March 2001" report cannot be the basis for an inference of scienter with respect to any alleged false statement in February 2001. In addition, there is nothing in the Complaint to suggest that the "March 2001" internal report was produced or made known to Notebaert in advance of his March 8, 2001 allegedly misleading statement.

upon which the Complaint, and the court of appeals, relied to support a strong inference of scienter. Pet. App. 23a; JA 104, ¶ 39.

In context, the claimed inference of scienter becomes extraordinarily weak, if not nonexistent.[23] Respondents are asserting that Notebaert was knowingly misleading the public about Tellabs' financial projections, and the strength of demand for the Company's principal product, for the entire first half of 2001. Yet, right in the middle of that time-frame, Notebaert announced that Tellabs experienced an unexpected fall-off in orders, and, as a result, reduced its financial projections by an amount greater than respondents allege that the reports (which may or may not have yet been known to Notebaert) suggest. The Seventh Circuit concluded that the inference of scienter was "strong" only by ignoring the illuminating context. The Reform Act rejects that approach.

3. The Seventh Circuit also relied on ambiguous allegations in concluding that the Complaint adequately alleged facts supporting a strong inference of scienter with respect to Notebaert's statements that the TITAN 6500 product was being shipped and that demand for the product was "strong."

First, the Seventh Circuit pointed to the allegation that, according to a former Tellabs sales director, "Tellabs management viewed weekly and monthly reports concerning a variety of issues, *including the status of product development*," and "Tellabs' sales personnel wrote up weekly sales projection reports." Pet. App. 24-25a; JA 155, ¶ 153(f). This allegation says nothing specifically about Notebaert's alleged knowledge regarding the TITAN 6500. Nothing about these allegations even suggests that any of these unidentified reports spoke about or called Notebaert's attention to issues related to the TITAN 6500. Instead, this allegation is nothing

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[23] The absence of any allegations providing a motive either for Notebaert or the Company to engage in fraud further weakens the inference of scienter, as discussed below. *Infra* at 50.

but a generic statement about the role of management in any corporation: to keep abreast of the broad financial condition of the company. As noted above, numerous cases have long recognized that such allegations do not support an inference of scienter, much less a strong one. *Supra* at 40-41.

Second, the Seventh Circuit erroneously concluded that respondents had alleged that "a former high-level sales executive[] reported that Notebaert knew that 'the TITAN 6500 was not ready for deployment despite Tellabs' public announcements.'" Pet. App. 25a (alteration in orginal). The allegation actually says that *other defendants* (as to whom the Section 10(b) claims were abandoned on appeal) knew that the TITAN 6500 was not ready for deployment. JA 107, ¶ 53. Respondents did not allege the same as to *Notebaert*.

As to Notebaert, the allegation says only, "Notebaert also knew about the TITAN 6500 problems." JA 108, ¶ 53. This allegation is strategically ambiguous regarding *what* "problems" Notebaert allegedly knew about and, importantly, *when*, especially in light of the fact that the paragraph in the Complaint begins by explaining that the TITAN 6500 had suffered development problems from 1998 through 2001 "and thereafter." *Id.* at 107, ¶ 53. The Complaint does nothing to exclude the possibility that, for example, Notebaert knew only of alleged problems with the TITAN 6500's development from 1998 and 1999. Further, the confidential informant supporting this allegation had left the Company before the class period had begun. JA 91; Pet. App. 74a. There is thus little reason to believe that the ambiguous allegation regarding Notebaert is addressed to information in Notebaert's possession at the time he made the allegedly false statements, which is *after* the informant left the Company.

4. For all the reasons identified above, the allegations in this case fall far short of satisfying the Reform Act's "strong inference" standard. But even if the ambiguous allegations discussed above were sufficient to make this a close case, there still would remain one powerful reason to dismiss the

Complaint. The Complaint here fails to identify any plausible motive for Notebaert to have committed fraud for the limited period from December 11, 2000 to June 19, 2001. The Complaint does not allege that Notebaert personally benefited financially, through stock sales or otherwise, during the seven-month period that the stock price allegedly was artificially inflated. Nor does the Complaint allege that Tellabs benefited in any way. Plaintiffs do not allege that there were any Company activities during this limited period of time—such as offerings, mergers, or exchanges—that would somehow have been facilitated by an artificially inflated stock price.

The absence of any allegations of motive color all the other allegations putatively giving rise to an inference of scienter. Respondents would have this Court believe that Notebaert began to execute a scheme to defraud investors and inflate the Company's stock price beginning in December 2001, and suddenly ended the scheme only seven months later, for no reason. This leap of faith is not the sort of inference courts lightly indulge. *Shields*, 25 F.3d at 1130 ("It is hard to see what benefits accrue from a short respite from an inevitable day of reckoning."); *supra* at 36-37. And in this case, the absence of motive must be combined with the fact that Notebaert publicly announced in the middle of the seven-month period that the Company's customers were exercising new-found caution in placing orders, and that the Company's financial outlook was weakening. Viewed in their full context, respondents' strategically ambiguous allegations support at most the weakest of inferences of scienter. The inference all but disappears. If the allegations in this Complaint give rise to a strong inference of scienter, then the strong inference standard of the Reform Act is a dead letter.

CONCLUSION

For the foregoing reasons, the decision of the Seventh Circuit should be reversed.

Respectfully submitted,

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No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED and RICHARD C. NOTEBAERT,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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CONSTITUTIONAL PROVISION INVOLVED

U.S. CONST. amend. VII provides:

> In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise re-examined in any Court of the United States, than according to the rules of the common law.

STATEMENT OF THE CASE

The Second Consolidated Amended Class Action Complaint ("SAC") identifies, by description, 26 persons,[1] including 25 former Tellabs employees, with knowledge and information concerning the allegations of wrongdoing relevant to the core products at issue — the TITAN 5500 ("5500") and the TITAN 6500 ("6500"). The Seventh Circuit noted: "[M]any of the informants were in a position to provide reliable information whether Birck's and Notebaert's statements were false and material and whether Birck and Notebaert knew this to be the case." (Pet. App. 11a) The independent sources corroborate one another and are corroborated by other particularized facts in the SAC, creating a strong inference that petitioners knew of, or at the very least recklessly disregarded, the severe problems affecting the 5500 and 6500, which jeopardized the Company's overall performance and prospects.

Tellabs and Its Core Products

Tellabs is a global supplier of optical networking, broadband access, and voice-quality enhancement solutions to telecommunications carriers and internet service providers. (JA 94, ¶2) In 2000, optical networking systems accounted for approximately 64% of its sales. (JA 101, ¶30) 5500 — Tellabs' principal seller in this category — was the Company's

[1] A twenty-seventh source provided information only with respect to Tellabs' SALIX product, which is no longer at issue.

"flagship," according to Tellabs' 2000 10-K.[2] (*Id.*) According to Tellabs' 2000 Annual Report, one of a small handful of "major new products" that Tellabs "began selling" in 2000 was 6500. (JA 127, ¶93) The central importance of 5500 and 6500 to Tellabs' success compels a powerful inference that Tellabs and Notebaert, who, as CEO and President throughout the Class Period, ran the Company at the highest levels, knew about serious problems affecting those products.

Falling Demand for Tellabs' "Flagship" 5500

By mid-2000, well before the Class Period (December 11, 2000 through June 19, 2001), Tellabs' customers were experiencing severe business deterioration and consolidation. (JA 94-95, ¶¶3, 4) With full knowledge of this dramatic slowdown in the telecommunications and internet sectors, petitioners falsely reassured investors that Tellabs' key products were continuing to enjoy strong demand. Yet, demand for 5500 — Tellabs' "best seller" — was, in fact, slowing substantially. (JA 103-05, ¶¶34-45) Numerous independent confidential sources confirmed the drop in demand for 5500, identifying specific customers that significantly reduced their orders, including Verizon Communications, Inc. ("Verizon"); SBC Communications, Inc. ("SBC"); Lexcom; and Telcobuy.com — the Company's major customers and distributors.[3] (JA 103, 105, 111-13, ¶¶35, 37, 43, 67-71) The importance of Tellabs' relationships with such key customers as Verizon and SBC further supports a strong inference that petitioners were well aware of significant decreases in those customers' orders and improper sales practices affecting them. Moreover, the richly particularized complaint demonstrates:

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[2] Tellabs' 2000 Annual Report similarly identified 5500 systems as its "core products." (JA 101, ¶30)

[3] Sources confirmed that Verizon, which alone accounted for over 19% of net sales in 2000, was Tellabs' largest customer for 5500 in 2000 and 2001. (JA 102, ¶33) Tellabs' three largest distributors included Telcobuy.com and Lexcom. (*Id.*)

• According to a Tellabs installations supervisor, in late 2000, there was a roughly 25% reduction in 5500 orders from Verizon, Tellabs' largest customer. (JA 130, ¶35) A Tellabs operations manager reported that, in January 2001, Verizon orders declined by about 50%. (*Id.*) According to a Tellabs executive account manager and regional manager, during the fourth quarter 2000 and throughout 2001, Verizon failed to execute millions of dollars of projected 5500 orders. (JA 105, ¶43)

• According to a Tellabs customer manager, as early as November 2000 (before the Class Period), Tellabs' customers were not buying: "it got slower and slower." (JA 104, ¶41)

• According to a Tellabs business development manager, by early 2001, sales of Tellabs' products were declining. (JA 103, ¶38) A Tellabs sales director also recounted that 5500 sales declined noticeably by then. (JA 111, ¶65) According to a mid-level Tellabs distribution employee, by the beginning of the first quarter of 2001, Tellabs had no orders and distribution personnel were told to go home early. (JA 113, ¶72)

• According to a team project manager for a product distributor, Tellabs stopped taking parts used to manufacture its products by the beginning of 2001. (JA 105, ¶44)

• According to a Tellabs marketing manager, Tellabs had excess 5500s on hand in late 2000/early 2001 and had "tons" of excess 5500s, and other products, on hundreds of racks in a warehouse; some systems sat on the shelves for six months to a year. (JA 104-05, ¶¶42, 45)

• According to a Tellabs engineer who held various managerial positions and who viewed the reports in question, Tellabs' finance department's internal quarterly reports showed declining demand in the third and fourth quarters of 2000 for 5500 and other Tellabs products. According to a Tellabs market analyst, quarterly reports concerning the profitability of Tellabs' products — reports accessible on Tellabs' database system —

showed a decline in 5500 demand by March 2001.[4] (JA 104, 155, ¶¶40, 153(d))

• According to a Tellabs marketing strategy executive, a $100,000 study performed for Tellabs by Probe Research, an independent firm, completed in or about early 2001, confirmed a steep drop in the number of T1 circuits, the main source of demand for 5500 systems. (JA 103-04, ¶39) That study was consistent with Tellabs' finance department's internal quarterly reports, which reflected a decline in 5500 demand as early as the second half of 2000. (JA 104, 155, ¶¶40, 153(d))

• An internal report prepared by Tellabs' marketing strategy department accurately concluded that, because of the T1 decline, 5500 revenue would fall by about $400 million (a huge and extremely significant decline given that Tellabs had no other products to take up the shortfall). That report was discussed at marketing strategy meetings, and was widely circulated to at least 10 executives, including individuals who reported directly to senior management (*e.g.*, the head of marketing strategy, who reported directly to Tellabs' Chairman). (JA 104, ¶39) Tellabs' mergers and acquisitions group also gathered market data, and fed it to Tellabs senior executives. (JA 159, ¶169)

• Tellabs senior management was in direct contact with the Company's customers. For example, according to a business

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[4] Tellabs executives also were provided daily computer reports concerning product bookings and revenue. A high-level Tellabs sales executive related that top management reviewed those reports regularly. (JA 155, ¶153(e)) Tellabs sales personnel produced weekly sales projections. (JA 155, ¶153(f)) In addition, Tellabs management was kept apprised of customer purchases and buying plans to ensure compliance with federal regulations and FCC supplier diversity requirements. (JA 159, ¶168) Notebaert had daily calls with fellow executives to stay on top of everything, and had weekly revenue calls concerning how Tellabs would "make its numbers." (JA 156, ¶153(g)) Notebaert also communicated with employees at town hall meetings, worked closely with the sales teams, and received sales personnel briefings on product status. (JA 109, 154, 156, ¶¶60, 153(a), 154)

development manager, Tellabs' Senior Vice President of Business Operations attended quarterly meetings with senior persons at Verizon, AT&T, and other important Tellabs customers. Tellabs management therefore knew how much customers were buying and planning to buy. (JA 158, ¶164)

• According to a Tellabs materials manager, orders from every single 5500 customer declined throughout the Class Period. (JA 103, ¶37)

• According to a Tellabs sales manager, customers in Latin America were not buying 5500. (JA 103, ¶36)

6500 Development Problems

In contrast to petitioners' public statements, which portrayed the product as launched and being sold, 6500, one of the Company's most significant new products, was far behind schedule, failing lab tests, and not ready for release. According to confidential sources, senior management knew that 6500 was not ready and that it was failing evaluations, and, in fact, visited customers in connection with those failures. (JA 107, 111, 157, 159-60; ¶¶50, 53, 67, 159, 171) A high-level Tellabs sales executive confirmed that Notebaert, and other senior executives, knew about 6500 problems.[5] (JA 107-08, 159-60, ¶¶53, 171-72)

• The high-level Tellabs sales executive also related that 6500 was almost two years late to market; its slow development was evident from 1998 through 2001. Customers that evaluated 6500 in their labs realized it "was not even close to being ready." Due to the delay, Tellabs lost approximately $50 million to $60 million of sales, and lost business to Alcatel. (JA 107-08, 159-60, ¶¶52-53, 171)

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[5] Although the sales executive left Tellabs shortly before the Class Period, he had worked at the Company for many years while 6500 was being developed (JA 91) and therefore clearly was in a position to know about 6500 development problems and what Notebaert knew about them.

• A Tellabs marketing manager confirmed that 6500 was failing customer evaluations. Tellabs' Senior Vice President of Product Development made numerous visits to customers regarding failed evaluations. (JA 107, ¶50)

• According to another high-level Tellabs sales executive, by October 2001, four months after the Class Period, there had been very few trials of 6500. (JA 106, ¶48) That is corroborated by a Tellabs distribution employee, who related that Tellabs did not make actual sales of 6500 or even have the product in its warehouse until after mid-September 2001. (*Id.*)

• According to a Tellabs project manager, even two months after the Class Period ended, 6500 still was not released. A Tellabs consultant also confirmed that 6500 was not approved by the Regional Bell Operating Companies. (JA 106, ¶48)

• According to a Tellabs senior business manager, at least since September 2000, Sprint network traffic, and hence demand for 6500, was dropping. (JA 106, ¶49)

• According to a Tellabs executive account manager, Tellabs was having difficulties testing 6500 and, in fourth quarter 2000 and first quarter 2001, Tellabs product managers were working to fix its defects and hoped to release the product in first quarter 2002, many months after the Class Period ended. (JA 107, ¶51)

• According to a former Tellabs marketing strategy executive, customers thought 6500 took too much space in comparison to its bandwidth capacity. Customers explained that competitor Ciena's product provided more bandwidth. Tellabs repeatedly attempted, without success, to sell its 6500 to major customers Verizon, BellSouth, and SBC. (JA 106, ¶47)

• Tellabs management received weekly and monthly reports concerning product development status. Tellabs sales personnel wrote weekly reports concerning sales projections and field trials, as well as customer maintenance reports, which updated trial status. (JA 155, ¶153(f))

Defendants' Misrepresentations Concerning 5500 and 6500

Despite their awareness of serious problems with 5500 and 6500, Tellabs, including Notebaert, made a series of materially false and misleading statements that inaccurately assured the market that 5500 demand remained strong and that 6500 was ready, and thereby artificially inflated Tellabs' stock price throughout the Class Period. The Seventh Circuit found the following actionable:

- Tellabs' December 11, 2000 press release: "The TITAN 6500 system is available now." (JA 113, ¶73)

- In Tellabs' 2000 Annual Report (issued February 14, 2001), Notebaert responded to the "frequently asked question" "Your core business is built on the TITAN 5500 — are you worried that this product has peaked?": "No . . . it's still going strong." (JA 126, ¶91)

- During a conference call on March 8, 2001, in response to an analyst's inquiry whether Tellabs was experiencing "any weakness there at all" as to 5500, Notebaert stated: "No, we're not. We're still seeing that product continue to maintain its growth rate; it's still experiencing strong acceptance." (JA 132, ¶102)

- Notebaert also represented during the March 8 analyst conference call: "Interest in and demand for the 6500 continues to grow. . . . We continue to ship . . . 6500 through the first quarter. We are satisfying very strong demand and growing customer demand." (JA 131, ¶100)

- During an April 6, 2001 conference call, Notebaert told analysts: "[E]verything we hear from the customers indicates that our [end] user demand for services continues to grow."[6] (JA 137, ¶114)

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[6] Petitioners' bald assertion (Pet. Br. 8 n.5) that Notebaert's statement clearly refers to customers of Tellabs' customers, whose demand was continuing to grow, is entirely unsupported by the record and is an improper attempt to present factual issues for resolution at the pleading stage.

• During the same call, responding to a question whether Tellabs was still on track to recognize 6500 revenue in the second quarter, Notebaert again claimed: "the 6500 is showing strength . . . we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong. . . ." (JA 138, ¶117)

Petitioners' Unfounded Representations Concerning Tellabs' 2001 Performance

In addition, petitioners made projections for 2001 that had no reasonable basis given the lack of demand and production delays. Thus, through at least March 2001, Tellabs, including Notebaert, repeatedly falsely assured the market that it expected 30% growth in revenues and earnings for 2001.[7] (JA 114-16, ¶¶76-77; JA 120-22, ¶85; JA 130-31, ¶99; JA 131, ¶100)

Even after Tellabs modified its guidance in March and April 2001, in the face of disappointing first quarter results, petitioners continued to make overstated revenue projections and to reassure the public about the Company's prospects notwithstanding what petitioners knew about collapsing demand.

Thus, on March 7, 2001, Tellabs reduced first quarter guidance slightly, but simultaneously continued to assure investors, without a reasonable basis for doing so, that "[g]rowth in Tellabs' core optical networking business [*i.e.*, the 5500] remains strong" and that it "expects to recognize TITAN 6500 system revenues in the second quarter." Notebaert stated: "Given the strong acceptance of the new TITAN 6500, we continue to target 30 percent growth in revenue and earnings for the year." (JA 15 & 130, ¶99; *see also* JA 20 & 131-32, ¶¶100-103) When an analyst inquired about Tellabs' reaction to certain competitors' lowered expectations during a March 8, 2001 conference call, Notebaert, with considerable contrary knowledge, responded:

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[7] Tellabs' 2000 10-K, filed March 29, 2001, which Notebaert signed, represented that the Company was "on track to meet its objective of $6 billion in annual revenues by the year 2003." (JA 133, ¶107)

"we haven't gotten any indication, I haven't gotten any indication from any of our major clients, major customers, of a downturn in the segment we're in." (JA 132, ¶103)

On April 6, 2001, with the release of actual first quarter 2001 results imminent, Tellabs reduced further its projection for the quarter, but did not modify its guidance for the full year. (JA 31-42 & 137-39, ¶¶113-18) At the same time, petitioners again represented falsely that demand "continues to grow" (JA 34 & 137, ¶114) and that "the 6500 is showing strength . . . The demand is very strong."[8] (JA 37 & 138, ¶117)

Then, on April 18, 2001, the Company again lowered its guidance but, notwithstanding what petitioners knew about falling demand for the Company's core products, still projected full-year 2001 revenues within the range of $3.6 billion to $3.7 billion, a very substantial increase over 2000.[9] (JA 43-73 & 140-141, 147-48, ¶¶121, 142)

Thus, far from negating any inference of wrongdoing, petitioners continued to misrepresent Tellabs' prospects, as the SAC clearly alleges. (JA 132, 139, 141, ¶¶104 [March 7, 2001], 119 [April 6, 2001], 122 [April 18, 2001])

Petitioners' assertion (Pet. Br. 5, 47) that Tellabs' first quarter 2001 reported revenues increased by 21% over the previous year evidencing continued growth is misleading.[10]

[8] Notebaert also gave false assurances that there was only a temporary deferral of 5500 orders: "The good news there is that the orders weren't cancelled. It was just do it after the end of the quarter." (JA 37 & 138-39, ¶¶116, 119(b))

[9] For 2001, Tellabs ultimately reported net sales of less than $2.2 billion and a net loss of $182 million — a decline from 2000 of more than 35% in net sales and about 125% in net earnings. (JA 147-48, ¶142)

[10] In fact, first quarter 2001 net earnings were about $123 million. First quarter 2000 earnings *before the cumulative effect of a change in accounting principle* were virtually the same — about $121 million. (JA 47) Revenues fell by more than 24% from the fourth quarter 2000 to the first quarter 2001. (JA 118, 141, ¶¶81, 123(a))

Tellabs' 2000 10-K states that product revenue is recognized only "when all significant contractual obligations have been met, including the terms of the shipment, and collection of the resulting receivable is reasonably assured." *See* Defs.' App. of Materials Cited in the Mem. in Support of Defs.' Mot. to Dismiss, Tab 7 at 122-23. Accordingly, a decline in demand would affect revenues on a delayed basis.[11] Therefore, it is apparent that the dramatic drop in sales for the second quarter 2001 was the result of earlier reductions in orders, which is consistent with the SAC.

Channel Stuffing, Backdated Sales, and Other Deceptive Devices to Hide Falling Demand

To create a false picture of robust demand, petitioners engaged in numerous covert deceptive practices, including channel stuffing (JA 110-13, ¶¶62-71); over-inventorying, *i.e.*, jamming distributors with unsellable product (JA 111-13, ¶¶66-69, 71); writing phony purchase orders and delivering products customers had not ordered (JA 110-12, ¶¶63, 68); and backdating sales (JA 112, ¶70). Such practices falsely inflated Tellabs' fourth quarter 2000 results. (JA 122, ¶86(a)) A senior Tellabs business manager reported that management approved channel stuffing, and that Notebaert had direct involvement with and knew about the channel stuffing, which a high-level sales executive confirmed. (JA 111, 156-57, ¶¶67, 156)

• According to the same sales executive, Tellabs employees *fabricated* purchase orders and Tellabs' Verizon team used channel stuffing as a strategy. (JA 110, ¶63) Petitioners' channel-stuffing sales practices were so egregious Verizon's Chairman complained to Tellabs. (JA 112, ¶71)

• The senior business manager related that the magnitude of Tellabs' channel stuffing of 5500 in late December 2000 was "extraordinary" (JA 111, ¶64); that channel stuffing in December

[11] On March 8, 2001, Notebaert explained with regard to 5500: "We're in the process of installing ... a large number of frames that we shipped in the fourth quarter..." (JA 132, ¶102)

2000 involving SBC alone amounted to roughly $20 million; that Telcobuy.com and Verizon also were victimized by the channel stuffing; that Tellabs paid VARs[12], including Telcobuy.com, a certain percentage, 5% or 10%, to hold inventory, an abnormal practice in the industry; that Telcobuy.com wanted to return the product because it realized it could not sell it to SBC and that Tellabs had jammed Telcobuy.com; and that approximately $10 million to $15 million of inventory came back in 2001 (JA 111, ¶67).

• A Tellabs customer service accounts representative recounted that Tellabs sent customers unwanted product (especially 5500); that customers returned 5500 merchandise as soon as it showed up; that, although customer sites often were not ready, Tellabs delivered product anyway to make its revenue numbers; that he processed millions of dollars of returns, mostly 5500s; that returns were so heavy during early 2001 extra storage space had to be leased; that returns in the first three months of 2001 were in the millions of dollars; and that Verizon and Telcobuy.com were heavily returning product. (JA 111-12, ¶68)

• A Tellabs marketing manager related that Tellabs definitely channel stuffed and loaded up distributors "big and fat" at the end of the fourth quarter 2000 (especially in December), and that distributors were upset and later returned the product. (JA 111, ¶66)

• Another Tellabs marketing manager related that Tellabs got "creative" to meet fourth quarter 2000 and early 2001 investor expectations, including offering discounts and other incentives (not disclosed to the investing public), and shipping to distributors (including shipping 5500s to Lexcom in early 2001) without the ultimate customer's agreement to purchase,

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[12] Value added resellers ("VARs") are third parties that work with Tellabs to handle customer services, including engineering site surveys, installations, and testing services, and also distribute Tellabs' products. (JA 93)

as is customary, which resulted in returns the subsequent quarter. (JA 112, ¶69)

• According to the same marketing manager, to meet earnings expectations, Tellabs *backdated* sales for the 5500 — pulling sales to larger customers from the first quarter 2001 into the fourth quarter 2000. (JA 112, ¶70)

The deliberate nature of channel stuffing, sales backdating, and other deceptive practices also creates a strong inference of petitioners' knowledge. Tellabs' undisclosed efforts to accelerate sales by channel stuffing hardly can be viewed as innocent in light of the SAC's allegations that employees fabricated purchase orders (JA 110, ¶63); that Tellabs sent customers unwanted 5500s (JA 111-12, ¶68); that Tellabs backdated sales (JA 112, ¶70); and that Verizon's Chairman even called Tellabs to complain about channel stuffing (JA 112, ¶71).

Petitioners' self-serving speculation that Notebaert's participation in channel stuffing might only have involved fashioning customer discounts[13] has no record support. In any event, innocent or not, such *undisclosed* discounts, and other deliberate practices intended to inflate sales, are strong confirmation of weakening demand by the fourth quarter of 2000 and petitioners', including Notebaert's, awareness thereof.

Tellabs' June 19, 2001 Announcement

After trading closed on June 19, 2001, the Class Period's last day, Tellabs, having known the truth for months, issued a press release dramatically revising its second quarter guidance, reducing projected revenues, by approximately $300 million, to $500 million and projected earnings per share from $.29 to breakeven (before restructuring and other charges). Contrary to previous assurances that the telecommunications industry slowdown was not affecting Tellabs, the Company

[13] The SAC alleges that the incentives Tellabs offered, which were not disclosed to the investing public, were excessive, unusual, and departed from ordinary business practices. (JA 110, ¶62; *see also* JA 111-13, ¶¶67, 71)

acknowledged: "The dramatic changes affecting the landscape of the telecommunications marketplace have continued to impact Tellabs." (JA 144, ¶131)

During a subsequent analyst conference call, Tellabs attributed the severe revenue shortfall to a massive reduction in 5500 sales. (JA 145, ¶132) Further confirming the severity of Tellabs' problems, Notebaert admitted that the revenue collapse affected Tellabs' business "across the board." (JA 145, ¶133)

A June 19, 2001 article titled "Tellabs Plays Mini-Nortel with Steep Shortfall" appearing in TheStreet.com noted: "While it was not a total surprise on Wall Street that Tellabs was having a bad quarter, the size of its shortfall came as a big shock. 'Mind-numbing,' as one New York hedge fund manager put it." (JA 146, ¶136)

The next day, June 20, the trading price of Tellabs common stock fell $5.16 per share, or more than 24% (the greatest percentage decline in the history of Tellabs stock), on extraordinary volume of almost 36 million shares (five times the average daily volume during the Class Period). (JA 145-46, ¶¶135, 137) The price of Tellabs stock has never recovered. (JA 146, ¶139)

Notwithstanding their unqualified assurances to investors as late as March 2001 that 5500 was "continu[ing] to maintain its growth rate" and was "still experiencing strong acceptance," and that Tellabs continued to expect 30% growth in revenues and earnings for 2001, petitioners ultimately admitted they had been well aware, by at least "early ... 2001," that demand was falling dramatically. Corroborating other facts pleaded in the SAC showing early declining demand, Notebaert's post-Class Period letter to shareholders in the 2001 Annual Report admitted: "*Early in 2001, as our customers reduced capital spending and expressed caution about the future, Tellabs began a deep process of self-examination.*"[14] (JA 147, 160; ¶¶141, 172)

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[14] Throughout, emphasis is indicated by italics and, unless stated otherwise, is added in quotations.

The Annual Report also revealed that, in April 2001, Tellabs had begun a series of layoffs, ultimately reducing its workforce by about 27%. Tellabs closed manufacturing plants in Ireland and Texas, consolidated product development and other functions from 30 facilities into 20, and cut expenses dramatically. (JA 147, 159, ¶¶141, 170) It is a strong inference that the admitted-to "self-examination" that led to these moves and the planning of such dramatic cuts began at least earlier that year.[15]

Diametrically opposed to all of Tellabs' Class Period public assurances of substantial, continued growth, for the second quarter 2001, Tellabs ultimately reported net sales attributable to products of only $407,701,000 and a net loss of $174,702,000 — a drop from the second quarter 2000 of more than 43% in net sales and more than 211% in net earnings. For the full year 2001, Tellabs reported net sales of $2,199,700,000 and a net loss of $182,000,000 as compared to net sales of $3,387,400,000 and net earnings of $730,800,000 for 2000 — a decline of more than 35% in net sales and about 125% in net earnings. Further confirming the severity of Tellabs' problems, the Company reported a net loss of $313,100,000 for 2002. (JA 147-48, ¶142)

The sheer magnitude of the Company's problems, and all the other particularized facts in the SAC, judged in their totality, as they should be, support an overwhelming inference of Tellabs' and Notebaert's scienter that meets any rational interpretation of the statutory words "strong inference."

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[15] According to a Tellabs project manager, by March 2001, information circulated throughout the Company that capital expenditures would be cut because of falling sales. (JA 159, ¶170) Tellabs discontinued receiving production parts in early 2001. (JA 105, ¶44) Inventories piled up in late 2000/early 2001. (JA 104-05, ¶¶42, 45)

SUMMARY OF ARGUMENT

The Private Securities Litigation Reform Act of 1995 ("PSLRA") reaffirms Congress' longstanding and firm commitment to protect investors and simultaneously establishes a procedural regime that allows meritorious cases to proceed, abates frivolous ones, and promotes uniform application of the pleading requirements. In construing the PSLRA's strong inference requirement, this Court should be mindful of these policies.

This Court has held that securities actions are subject to the "preponderance of the evidence" standard at summary judgment and trial and should adopt a pleading standard consistent with that burden of proof. The PSLRA's language makes clear that a plaintiff can satisfy the strong inference standard by pleading particularized allegations that support a reasonable conclusion that, more likely than not, defendants acted with scienter. The standard on a motion to dismiss should not be more burdensome for a plaintiff than at summary judgment or trial.

The SAC sets forth many particularized facts indicating that petitioners acted with scienter. Detailed factual allegations based on information provided by 26 knowledgeable confidential sources and respondents' investigation demonstrate that Tellabs and Notebaert knew about the serious problems affecting sales of its most important products. The SAC further particularizes petitioners' actual knowledge of reduced demand and their resort to several nefarious practices to create a false picture of continuing demand. The Seventh Circuit faithfully articulated Congress' intent and properly applied the PSLRA pleading standard by examining all the complaint's allegations to determine whether a reasonable person could be convinced that a strong inference of scienter had been shown.

Congress did not intend to abolish the long-standing principle that, on a pleading motion, a plaintiff is entitled to have the complaint construed in its favor. Nor did Congress

authorize courts to weigh conflicting inferences put forth by defendants or to speculate about non-culpable explanations. Rather, the statute directs courts to determine whether there is a strong inference for *plaintiff*, not the defendant.

Congress adopted the strong inference standard from Second Circuit case law – "the most stringent pleading standard" at the time. That court's formulations did not allow district courts to weigh competing inferences or speculate as to innocent explanations for defendants' conduct. Since the PSLRA's enactment, most courts of appeal have adopted the same view of the strong inference standard, and do not weigh inferences. This Court should validate that practice.

Petitioners ask the Court to ignore the PSLRA's actual language and fabricate an impossible-to-meet heightened pleading burden that obliges a plaintiff to provide sufficient evidentiary detail to foreclose any possibility that the defendant's intent was not fraudulent. Such a requirement has no basis in more than a decade of case law applying the PSLRA, and is at odds with the established principle that a plaintiff is not required to plead detailed evidence or to prove the merits of its case in the complaint. The variant super-heightened pleading standards conjured up by petitioners and supporting *amici* are very likely to throw out the meritorious wheat along with the chaff. The PSLRA was never intended to leave the securities marketplace so vulnerable to malfeasance.

This Court has long held that the Seventh Amendment jury trial right is violated when the jury's role as fact-finder is interfered with or obstructed. Any interpretation of the PSLRA's standard requiring more than an inference strong enough to support a reasonable jury's finding that the defendant acted with scienter violates the Constitution's jury trial guarantee. Whether a complaint's allegations support a finding of scienter is a factual matter for the jury, unless the district court can conclude as a matter of law that no reasonable person could find that the defendant acted with the prohibited state of mind.

This Court should not be swayed by the outdated pre-PSLRA data relied on by petitioners and supporting *amici* or by the melange of extra-record unverified data and self-serving commentary they promote, hoping that this Court will legislate an extreme pleading standard. The PSLRA has had a major impact on securities litigation: the dismissal rate has *more than doubled* in the last few years, a large percentage of cases are effectively being led by competent and involved institutional investors, and, most recently, there has been a decline in filings. The complaint that private securities actions imperil the United States' competitive position in the global marketplace is largely unfounded, particularly given the actual data showing that our financial markets are thriving. The PSLRA has realized Congress' desire to curtail meritless securities litigation. But, like sharks scenting blood in the water, an array of corporate interests has mobilized in an attempt to administer a coup de grace to private securities enforcement by convincing this Court to raise the pleading standard to unprecedented heights.

ARGUMENT

I. ON A MOTION TO DISMISS COURTS SHOULD GIVE PLAINTIFFS THE BENEFIT OF ALL REASONABLE INFERENCES, AND SHOULD NOT WEIGH COMPETING INFERENCES OR POSSIBLE EXCULPATORY EXPLANATIONS

A. The PSLRA Does Not Abolish The Long-Standing Principles Governing Motions To Dismiss

Under the pleading regime long in effect: "The issue is not whether a plaintiff will ultimately prevail but whether a claimant is entitled to offer evidence to support his claims," and "the allegations of the complaint should be construed favorably to the pleader." *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974), *overruled on other grounds*, *Davis v. Scherer*, 468 U.S. 183 (1984). Nothing in the PSLRA abolishes those principles, amends Rule 12(b)(6), or terminates the canons that a plaintiff need not plead detailed evidence (*e.g.*, *Conley v. Gibson*, 355

U.S. 41, 47 (1957)), is not required to plead facts exclusively in defendants' possession (*e.g.*, *In re Rockefeller Center Props., Inc. Secs. Litig.*, 311 F.3d 198, 216 (3d Cir. 2002)), and is entitled to the benefit of all reasonable inferences in plaintiff's favor (*e.g.*, *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 254 (1986); *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 161 (2d Cir. 2000)).[16] These precepts can be traced back to Chief Justice Marshall's statement 200 years ago that "[t]he party demurring admits the truth of the testimony to which he demurs, and also those conclusions of fact which a jury may fairly draw from that testimony" and "the testimony is to be taken most strongly against him, and such conclusions as a jury might justifiably draw, the Court ought to draw." *Pawling v. United States*, 8 U.S. [4 Cranch] 219, 221-22 (1808).

The PSLRA's plain language directs the court to determine whether there is *a* strong inference for *plaintiff*; it says nothing about weighing competing inferences. Nor does it direct the district court to speculate, without factual basis, whether non-culpable explanations might exist, or to evaluate their strength.

This Court has held repeatedly that a statute should not be interpreted to effect a radical departure from the procedural regime under the Federal Rules unless Congress has made it clear a departure is required. *Jones v. Bock*, 127 S. Ct. 910, 921 (2007); *Hill v. McDonough*, 126 S. Ct. 2096, 2103 (2006); *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 512-14 (2002); *Leatherman v. Tarrant County Narcotic Intelligence & Coordination Unit*, 507 U.S. 163, 168-69 (1993). In *Jones*, this Court stated: "[W]e have explained that courts should generally not depart from the usual practice under the Federal Rules on the basis of perceived policy concerns. . . . [T]hat is a result which must be obtained by the process of amending the Federal Rules, and not by judicial interpretation." 127 S. Ct. at 919 (citation and internal quotation marks omitted).

[16] This Court assumes that Congress is "aware of existing law when it passes legislation." *Miles v. Apex Marine Corp.*, 498 U.S. 19, 32 (1990).

Petitioners argue that, because of certain policy considerations they believe override the goal of preserving meritorious private securities claims, this Court should add super-heightened pleading requirements not found in the PSLRA and jettison the firmly established methodology that governs motions to dismiss. That position should be rejected as it was in *Jones*.

If the Court deems the statutory text ambiguous as to the meaning of the words "strong inference," it is appropriate to see whether the legislative history throws any light on its proper interpretation. *Diamond v. Chakrabarty*, 447 U.S. 303, 315 (1980). Nothing in the legislative history suggests courts must depart from the long-standing procedures governing motions to dismiss. To the contrary, as discussed in Point I(D), below, the legislative history confirms that Congress rejected attempts to include language in the PSLRA that would have deprived plaintiffs of their historic entitlement to all reasonable inferences in their favor.

B. Petitioners' Interpretation Of "Strong Inference" Conflicts With Congress' Intent To Support And Encourage Meritorious Private Securities Fraud Claims

This Court should seek to effectuate all of the PSLRA's objectives. Petitioners stress only the termination of groundless claims. However, this Court should abjure such tunnel vision and protect the other PSLRA objective: private enforcement of our securities laws to promote their effectiveness.[17] The Conference Committee described the final legislation's purposes:

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[17] Several of petitioners' supporting *amici* take this opportunity to engage in thinly veiled attacks on some of the basic underpinnings of private enforcement actions, such as the existence of a private right of action to enforce § 10(b), universal acknowledgement by the circuit courts that scienter includes recklessness, and even the very concept of auditors' liability for securities fraud. None of these subjects is encompassed within the question presented by petitioners.

> The overriding purpose of our Nation's securities laws is to protect investors and to maintain confidence in the securities markets, so that our national savings, capital formation and investment may grow for the benefit of all Americans.... Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs. This legislation seeks to return the securities litigation system to that high standard.

H.R. Rep. No. 104-369, at 59 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730,740.

This Court repeatedly has expressed its own belief that private securities fraud actions provide "a most effective weapon in the enforcement" of the securities laws and are a "necessary supplement to Commission action." *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964). Justice Kennedy recognized in his dissenting opinion in *Lampf v. Gilbertson*, 501 U.S. 350, 374 (1991), that the private right of action under §10(b) "has become an essential component of the protection the law gives to investors who have been injured by unlawful practices." *See also Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 344 (2005) ("the securities statutes seek to maintain public confidence in the marketplace [citation omitted] ... by deterring fraud, in part, through the availability of private securities fraud actions").

According to the Conference Committee Statement of Managers, Congress sought "to increase the likelihood that institutional investors will serve as lead plaintiffs by requiring courts to presume that the member of the purported class with the largest financial stake in the relief sought is the 'most adequate plaintiff.'" Congress was motivated by its belief "that

increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions." H.R. Rep. No. 104-369, at 61. By encouraging institutional investors to serve as class representatives and enacting other procedures designed to bring about responsible and vigorous class representation,[18] the PSLRA clearly sought to encourage well grounded securities fraud suits and to promote their effective prosecution.

Notwithstanding the vitriolic rhetoric of petitioners and supporting *amici*, the foundations of the republic are not about to crumble because defrauded investors seek relief from the companies that have cheated them. Indeed, the PSLRA's higher pleading requirements have led to dismissals nearly doubling. More than 38% of class action cases filed between 2000 and 2004 were dismissed,[19] and class action securities fraud filings "plunged to a record low" in 2006.[20]

Petitioners and supporting *amici* improperly present the Court with a hodge podge of articles, political diatribes, and self-serving commentary that does not provide a reliable factual record and that has nothing to do with the actual issue before the Court — interpreting the intent of Congress as reflected in the PSLRA. In effect, these presentations invite the Court to make economic policy and legislate, an invitation this Court should decline as being wholly inappropriate. Moreover,

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[18] 15 U.S.C. §78u-4(a)(3)(A)(i).

[19] Insurance Journal, *Federal Class Action Filings Plummet But Settlement Amounts Rise*, Feb. 21, 2007, *http://www.insurancejournal.com/news/national/2007/02/21/77078.htm*.

[20] *Securities Class Action Case Filings, 2006: A Year in Review*, Cornerstone Research (2007), at 1. *See also* Todd Foster, Richard I. Miller, Ph.D., Stephanie Plancich, Ph.D., *Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar*, NERA Economic Consulting, Jan. 2007 ("NERA Study"), at 1, 2, 4.

regardless of whether or not the PSLRA as written has achieved all its objectives, this Court's role is to enforce the words that Congress actually enacted, not to draft new requirements not embodied in the statute.

Petitioners' supporting *amici* complain that since the passage of the PSLRA, the average settlement amount in actions that survive motions to dismiss has increased. However, the reason for that increase may well confirm the apparent effectiveness of private actions. Many recent recoveries reflect the fact that the securities fraud landscape post-PSLRA has been dominated by a series of multi-billion dollar, high profile securities frauds. Private securities actions addressing those frauds resulted, for example, in settlements in Enron ($7.1 billion), WorldCom ($6.1 billion), AOL Time Warner ($2.65 billion), Royal Ahold ($1.1 billion), Nortel ($2.2 billion), and McKesson HBOC ($960 million). *See* NERA Study at 5, 11. Significantly, neither petitioners nor supporting *amici* have put forth any evidence demonstrating that the higher average settlement amounts are the result of frivolous securities litigation.

Petitioners' supporting *amici* also claim that securities class actions and intensified government regulation are causing the United States to lose its competitive position in the global capital marketplace. The Court should be skeptical of such statements absent a complete factual record. Indeed, in contrast to the Bloomberg & Schumer report that petitioners' supporting *amici* so heavily rely upon, many facts offer a very different picture. According to a Fortune magazine article in response to that report:

> 56 companies backed by venture capitalists went public in 2006 in the United States, raising a total of $3.72 billion, the highest number and largest amount raised since 2004, the year of Google, according to Dow Jones VentureOne. More broadly, a Thomson Financial survey of all U.S. IPO activity shows that

> the 189 IPOs last year raised nearly $43 billion, more than the $41.4 billion raised by 558 deals in 1997. In other words, there were fewer but higher-quality deals. More are on the way.

Adam Lashinsky, *IPOS still love U.S. Markets*, Fortune, Feb. 1, 2007, *available at http://money.cnn.com/ 2007/01/30/* markets/pluggedin_lashinsky_markets.fortune/index.htm.[21]

A major objective of the PSLRA has been achieved in that many significant institutions have stepped forward and are lead plaintiffs in numerous private securities class actions. It was certainly not the intent of Congress to encourage their active participation while at the same time enacting a pleading standard that would unreasonably impair their ability to prosecute meritorious cases.

Despite all this evidence, petitioners and supporting *amici* propose unrealistic standards that would encourage the district courts to go well beyond what Congress intended and would result in the dismissal of many well-grounded lawsuits. This Court should not articulate a pleading standard that will prove impossible – even for meritorious actions – to satisfy. In *Lampf v. Gilbertson*, 501 U.S. at 376-77, Justice Kennedy (dissenting) noted: "the real burden on most investors, however, is the initial matter of discovering whether a violation of the securities laws occurred at all. This is particularly the case for victims of the classic fraud-like cases that often arise under § 10(b) …." *Id.* at 377. Given that difficulty, especially with respect to establishing a defendant's state of mind, it is highly questionable whether even the complaints that ultimately led to multi-billion dollar recoveries in admitted frauds such as Enron and Worldcom would have survived a motion to dismiss under the Kafkaesque

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[21] *See* Brief to be filed on behalf of the German Association for the Protection of Share Holders et al. as *amici curiae*, confirming that "private enforcement of United States securities laws, encourages rather than discourages foreign investors to invest and foreign companies to list in the U.S. markets." (Brief at 7)

super-heightened pleading standard proposed by petitioners and supporting *amici*.

C. The Strong Inference Provision Requires The Complaint To Support A Reasonable Conclusion That, More Likely Than Not, Petitioners Acted With Scienter

Statutory construction begins (and may well end) with the statute's language. *E.g.*, *Alexander v. Sandoval*, 532 U.S. 275, 288 (2001). Petitioners and supporting *amici* rely heavily on carefully selected aspects of dictionary definitions of "strong," completely ignoring other meanings and the signification of "inference." In *Virginia v. Black*, 538 U.S. 343, 395-96 (2003), Justice Thomas' dissenting opinion contains the following quoted definition (emphasis in original): "*An inference*, sometimes loosely referred to as a presumption of fact, *does not compel a specific conclusion. An inference merely applies to the rational potency or probative value of an evidentiary fact to which the fact finder may attach whatever force or weight it deems best.*"[22] According to Webster's Third International Dictionary (2002), "INFER indicates arriving at an opinion or coming to accept a *probability* on the basis of available evidence."

An inference would be "strong" if the particularized allegations support a reasonable conclusion that the defendant probably — *i.e.*, more likely than not — had scienter. For example, the American Heritage Dictionary of the English Language (4th ed. 2004) includes "persuasive" and "cogent" as definitions of a "strong argument." Neither of these definitions requires a strong inference to have a "high likelihood" of correctness (the Solicitor General's proposed standard) or mean that there can be no substantial possibility that the inference is incorrect (in effect proposed by both petitioners and the Solicitor

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[22] The quoted passage is from 9 J. Wigmore, Evidence in Trials at Common Law § 2491(1), at 304 (Chad. rev. 1981).

General). For example, according to Webster's Online Dictionary: "An argument is *cogent* if, and only if, supposing the premises all to be true, then the conclusion is *probably* (but not necessarily) true." http:// www.websters-online-dictionary.org/definition/strong. Webster's Third New International Dictionary defines "persuasive" as "tending to persuade." The statute's language therefore connotes probability and tendency, not "high likelihood" or any more extreme formulation.

Thus, facts that could convince a reasonable person that a defendant probably acted with scienter qualify as giving rise to a strong inference. The SAC sets forth facts that clearly meet that standard, as the Seventh Circuit properly concluded.[23]

D. Respondents' Interpretation Is Consistent With The Second Circuit Standard, Which The PSLRA Adopted

Congress clearly took the strong inference pleading standard from the Second Circuit case law, recognizing that the Second Circuit had set forth "the most stringent pleading standard" of any circuit.[24] *See* H.R. Rep. No. 104-369, at 66

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[23] In *Cohen v. Koenig*, 25 F.3d 1168, 1174 (2d Cir. 1994), the Second Circuit specifically articulated the "more likely than not" formulation as plaintiff's pleading burden in a fraud action: "[S]ufficient facts were pleaded to suggest that plaintiffs may be able to prove that defendants *more likely than not* knew that their financial representations were false." *Id.* at 1174. At that time, the Second Circuit had already formulated the strong inference of scienter standard for application in fraud cases. *E.g.*, *Ross v. A. H. Robbins, Co.*, 607 F.2d 545, 558 (2d Cir. 1979). Although *Cohen v. Koenig* involved a common law fraud claim, the Second Circuit's "strong inference" pleading standard was not limited to federal securities law cases. Rather, it was that court's interpretation of Rule 9(b) as applied to fraud cases generally. *Cosmas v. Hasset*, 886 F.2d 8, 12-13 (2d Cir. 1989).

[24] *See Novak v. Kasaks*, 216 F.3d 300, 310 (2d Cir. 2000); *In re Advanta Corp. Secs. Litig.*, 180 F.3d 525, 533-34 (3d Cir. 1999).

(1995).[25] Nothing in the PSLRA's legislative history suggests that Congress meant to depart from the Second Circuit's express recognition that the strong inference test does not require or justify any departure from the well-settled rules that, on a motion to dismiss, the court must accept all factual allegations in the complaint as true and must draw all reasonable inferences in the plaintiff's favor.[26]

Indeed, Congress rejected a proposal, in H.R. 1058, that would have required plaintiffs to plead facts that "establish scienter" and would have denied plaintiffs the ability to plead "facts inconsistent" with a false statement to "establish scienter."[27] Petitioners and supporting *amici* effectively seek to resurrect the rejected language and supplant the long-standing rules governing motions to dismiss.

In 1998, Congress reaffirmed the PSLRA's intention to incorporate the Second Circuit standard. During its consideration of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), which preempts securities class actions under state law and limits defrauded investors to their remedies under the federal securities laws, concern was expressed whether certain

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[25] The Statement of Managers mentions that, although the scienter provision was based in part on the Second Circuit pleading standard, "it does not intend to codify the Second Circuit's case law interpreting this pleading standard," explaining that, for this reason, "the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness." *Id.* at 66 n.23. However, the legislative history contains no suggestion that the heightened pleading standard should not be applied consistent with the historic application by the Second Circuit and all other courts of the long-established rules that govern motions to dismiss.

[26] *E.g.*, *Rombach v. Chang*, 355 F.3d 164, 169 (2d Cir. 2004); *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 95 (2d Cir. 2001); *Citizens Utils., Co.*, 228 F.3d at 161; *Shields v. Citytrust Bancorp*, 25 F.3d 1124, 1127 (2d Cir. 1994); *Cosmas*, 886 F.2d at 11.

[27] *See* H.R. Rep. No. 104-50(I), at § 10A(b)(1995).

courts had been misinterpreting the PSLRA by imposing pleading requirements that were more burdensome than the Second Circuit's test. Banking Committee Report, at S. Rep. No. 182, at 11 (1998). The Conference Report on SLUSA reconfirmed that the PSLRA was intended to incorporate the Second Circuit pleading standard: "[I]t was the intent of Congress . . . *that the Reform Act establish a heightened uniform federal standard on pleading requirements, based upon the pleading standard applied by the Second Circuit Court of Appeals.*" H.R. Rep. No. 105-803 ("1998 Conf. Rep."), at 13-15 (1998), *as reprinted in*, 1995 U.S.C.C.A.N. 730. If there is any uncertainty or obscurity about the intent of Congress, its clear expression on this issue in 1998 is entitled to "significant weight." *Seatrain Shipbuilding Corp. v. Shell Oil Co.*, 444 U.S. 572, 596 (1980).

Over the last decade, the SEC repeatedly has taken the position in *amicus* briefs that Congress adopted the Second Circuit's pleading standard. The SEC has never before supported a "high likelihood" standard or a weighing of competing inferences. *See Amicus* Brief to be filed on behalf of the Amalgamated Bank, as Trustee, pp. 18-23 and Appendix thereto. In the Solicitor General's brief, the SEC has now done a remarkable about face. This Court has made clear it will accord "no special weight" to the views of the SEC when it presents a position that flatly contradicts the views it previously and persistently expressed. *See, e.g., Int'l Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 566-67 (1979); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 858 n. 25 (1975).

Even though the Second Circuit did not allow weighing of competing inferences or speculation as to possible exculpatory explanations, its standard constituted a difficult hurdle for plaintiffs. As the Solicitor General's brief recognizes, applying its strong inference standard, "the Second Circuit required the dismissal of numerous securities fraud complaints." (Brief at 14) (citations omitted). If this Court heightens the barrier even more, beyond what Congress intended, it will be exceedingly difficult to prosecute even highly meritorious securities actions.

Indeed, one empirical study suggests the PSLRA has discouraged meritorious litigation.[28]

E. Most Courts Applying The PSLRA Do Not Weigh Competing Inferences Or Speculate As To Non-Culpable Explanations

In assessing a complaint under the PSLRA, most circuits, including the Seventh Circuit, examine all the complaint's allegations to determine whether a strong inference of scienter exists, but do not limit themselves to the most plausible or strongest inference the complaint supports.[29] The appropriate decisional process was aptly described by the Tenth Circuit in *Pirraglia v. Novell*, 339 F.3d 1182, 1187-88 (10th Cir. 2003) (citations omitted):

> Our role at the 12(b)(6) stage is simply to determine whether the plaintiff raises a strong inference of scienter. *We emphasize that this process does not involve a "weighing" of the plaintiff's suggested inference against other inferences. Faced with two seemingly equally strong inferences, one favoring the plaintiff and one favoring the defendant, it is inappropriate for us to make a determination as to which inference will ultimately prevail, lest we invade the traditional role of the factfinder.* Thus, we reject the position of the Sixth Circuit that "plaintiffs are entitled only to the most plausible of

[28] Eric Talley & Gudrun Johnsen, Corporate Governance, Executive Compensation and Securities Litigation 25 (Univ. of S. Cal. Law Sch., Olin Research Paper No. 04-7, 2004), *available at* http://econpapers.repec.org/paper/bepusclwp/usclwps-1002.htm

[29] *E.g.*, *Makor Issues & Rights v. Tellabs, Inc.* (Pet. App. at 19a-20a); *Phillips v. Scientific-Atlantic, Inc.*, 374 F.3d 1015, 1017 (11th Cir. 2004); *In re Alpharma Sec. Litig.*, 372 F.3d 137, 151 (3d Cir. 2004); *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003); *Adams v. Kinder-Morgan Inc.*, 340 F.3d 1083, 1105 (10th Cir. 2003); *Goldstein v. MCI Worldcom*, 340 F.3d 238, 246 (5th Cir. 2003); *In re K-Tel Int'l Sec. Litig.*, 300 F.3d 881, 889 (8th Cir. 2002).

> competing inferences." If a plaintiff pleads facts with particularity that, in the overall context of the pleadings, including potentially negative inferences, give rise to a strong inference of scienter, the scienter requirement of the Reform Act is satisfied.

Likewise, most other courts of appeal do not weigh inferences adverse to plaintiffs on motions to dismiss. *See, e.g., Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1264 (11th Cir. 2006); *In re PEC Solutions, Inc. Secs. Litig.*, 418 F.3d 379, 387 (4th Cir. 2005); *Rombach*, 355 F.3d at 169; *In re Rockefeller Center*, 311 F.3d at 205-06, 224; *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 660 (8th Cir. 2001); *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 406-07, 424-25 (5th Cir. 2001).[30]

Although the Sixth Circuit has held that a strong inference is only the "most plausible" of competing inferences (*Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (en banc)), that court has qualified this approach, stressing: "When an allegation is capable of more than one inference, it must be construed in the plaintiff's favor. Our willingness to draw inferences in the favor of the plaintiff remains unchanged by the PSLRA." 251 F.3d at 553 (citation omitted). Subsequently, the Sixth Circuit expressed concern that, "for cases where a juror could conclude that the facts pleaded showed scienter, but that conclusion would not be the most plausible of competing inferences, a Seventh Amendment problem is presented." *City of Monroe Employees Retirement Sys. v. Bridgestone Corp.*, 399 F.3d 651, 683 n.25 (6th Cir. 2005).

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[30] On at least two recent occasions involving PSLRA motions to dismiss, the First Circuit criticized the district court for failing to give the plaintiff the benefit of all reasonable inferences, and for concluding instead that conflicting allegations undermined the sufficiency of the claim. *See In re Stone & Webster, Inc. Secs. Litig.*, 414 F.3d 187, 200 n.8 (1st Cir. 2005); *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 78 (1st Cir. 2002).

Although petitioners cite decisions in which, they argue, courts weighed competing inferences, in many instances the court actually was determining that there was no reasonable basis to draw any inference for plaintiff in the first place.[31] Obviously, the *weighing* process cannot begin unless the particularized allegations are sufficient to support an inference for plaintiff.

F. This Court Should Articulate A Standard Consistent With Its Rulings Concerning Dispositive Motions That Seek To Withdraw Factual Issues From The Jury

The Court should confirm a PSLRA pleading standard that embodies the same principles it has established for summary judgment and other dispositive motions. In *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242 (1986), this Court held that "the inquiry involved in a ruling on a motion for summary judgment or for a directed verdict necessarily implicates the substantive evidentiary standard of proof that would apply at the trial on the merits." 477 U.S. at 252. Thus, if plaintiff's burden at trial is to prove his or her case by a "preponderance of the evidence," a summary judgment motion "unavoidably asks whether reasonable jurors could find by a preponderance of the evidence" for the plaintiff. *Id.* The Court further held that, when plaintiff has a heightened burden of proof, plaintiff's ability to survive summary judgment — *i.e.*, the question whether plaintiff had sufficient evidence to demonstrate a genuine issue for trial —

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[31] For example, in *Gompper v. VISX, Inc.*, 298 F.3d 893, 896 (9th Cir. 2002), the Ninth Circuit recognized that on a motion to dismiss the reviewing court must accept the plaintiffs' allegations as true "and construe them in the light most favorable to the plaintiff," but cited the Sixth Circuit's *Helwig* decision for the statement that the strong inference requirement entitles plaintiffs to "only the most plausible of competing inferences." *Id.* at 897. *Gompper* itself did not actually weigh competing inferences. Rather, in substance, it held that plaintiffs had failed to plead facts that supported *any* inferences for them. *Id.* at 896-97.

would be measured in light of that higher standard. *Id.* at 255. Even so, this Court stated:

> Credibility determinations, the weighing of evidence, and the drawing of legitimate inferences from the facts are jury functions, not those of a judge, whether he is ruling on a motion for summary judgment or for a directed verdict. The evidence of the nonmovant is to be believed, and all justifiable inferences are to be drawn in his favor.

Id.

Respondents' ability to withstand the motion to dismiss and present their case on its merits should be measured in a manner comparable to the test faced by the plaintiff in *Liberty Lobby*. Just as the plaintiff in *Liberty Lobby* was entitled to all reasonable inferences, without any weighing of competing inferences, despite the heightened standard of proof, so too respondents should have the benefit of all reasonable inferences without any weighing of competing inferences. There is no reason for the standard on a motion to dismiss to be more burdensome for the plaintiff than the standard on a summary judgment motion, especially since the plaintiff has the benefit of discovery before it responds to the latter, but not when a PSLRA plaintiff responds to the former.

Precisely the same analogy exists — perhaps with even more force — between motions to dismiss for lack of scienter under the PSLRA and motions for judgment as a matter of law after trial. In *Reeves v. Sanderson Plumbing Prods., Inc.*, 530 U.S. 133, 150 (2000), this Court held that after reviewing all the evidence presented at trial, the district court "must draw all reasonable inferences in favor of the nonmoving party" and "must disregard evidence favorable to the moving party that the jury is not required to believe." *Id.* at 150-51.

Even without regard to the Seventh Amendment issue, discussed in Point II, below, as this Court noted in *Swierkiewicz*, 534 U.S. at 511: "It thus seems incongruous to require a plaintiff,

in order to survive a motion to dismiss, to plead more facts than he may ultimately need to prove to succeed on the merits. . . ." This comment by the Court is very much on point. The principal thrust of petitioners' position is to require respondents to plead far more than they would need to be allowed to present their case and possibly prevail at trial, in order to avoid dismissal.

G. The Seventh Circuit Decision Properly Implements The PSLRA's Heightened Pleading Standard

The decision below gives full effect to Congress' intent to raise the pleading standard. The Seventh Circuit did not rule that district courts should ignore complaint allegations that might provide support for defendants, and did not articulate a pleading standard that requires only a "reasonable" (rather than "strong") inference. After quoting the statute's strong inference pleading standard, the Seventh Circuit concluded that courts should "examine all of the allegations of the complaint and then ... decide whether collectively they establish such an inference." (Pet. App. 19a-20a)

In their desire to denigrate the work product of the court below, petitioners and supporting *amici* ignore the context and intent of the Seventh Circuit's statement that "we will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." (Pet. App. 20a). At this point in its opinion, the Seventh Circuit was stating its rationale for disagreeing with the Sixth Circuit as to whether district courts should weigh conflicting inferences. Consistent with the approach to dispositive motions taken in *Liberty Lobby* and *Reeves*, the Seventh Circuit expressed its concern, quoting *Pirraglia*, 339 F.3d at 1188, that if a reasonable juror could find for the plaintiff, it would invade the province of the jury for the court to weigh other competing inferences to see which is stronger. (Pet. App. 20a-21a)

Petitioners and supporting *amici* are simply wrong in arguing that the Seventh Circuit standard would return the courts

to pre-PSLRA standards.[32] The standard that court adopted and respondents advocate significantly intensifies the district court's scrutiny on a motion to dismiss. The operative inquiry under Rule 12(b)(6) is simply whether plaintiff has stated a legally cognizable claim for relief. As properly interpreted, the PSLRA and the Seventh Circuit's construction of it require the court to go further and find the case strong enough to warrant its submission at trial to the fact finder.

Petitioners and supporting *amici* not only unfairly misdescribe the Seventh Circuit's actual methodology and decision, but also overlook the many other PSLRA provisions that have rendered the prosecution of private securities actions even more difficult.[33]

H. Petitioners Would Require District Courts To Make Premature Factual Determinations And To Weigh Hypothetical Defenses Without A Proper Evidentiary Record

The Solicitor General argues that the district court should consider whether the allegations leave open "non-culpable explanations" of defendants' conduct, and should dismiss if the allegations allow any "substantial possibility" that the defendants might not have acted with scienter. Similarly, petitioners argue that district courts should penalize plaintiffs if they omit details

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[32] Petitioners and supporting *amici* conveniently ignore that the Seventh Circuit held respondents to a high standard and affirmed dismissal of their § 10(b) claim against Michael Birck, Tellabs' Chairman, for failure to plead scienter adequately. (Pet. App. 23-24a)

[33] In addition to the strong inference requirement, the PSLRA heightened the requirement for pleading fraud so that state of mind, and not merely falsity, must be alleged with "particularity." 15 U.S.C. §78u-4(b)(1)(B). Plaintiffs also have to plead with particularity their factual basis for allegations proffered on information and belief. *Id.* Plaintiffs are automatically precluded from conducting discovery until the court resolves motions to dismiss — a further change from the pre-PSLRA approach taken by many courts, 15 U.S.C. §78u-4(b)(3)(B) – and are subject to mandatory sanctions in certain situations.

that would clarify whether defendants' conduct was either innocent or culpable. (Pet. Br. at 38) Such proposals would require dismissal unless plaintiff pleaded in such all-encompassing evidentiary detail as to foreclose any substantial possibility that valid defenses exist. There is no rational or reasonable justification or precedent for this hyper-elevated pleading standard.

The unprecedented standards proposed by petitioners and supporting *amici* conflict with the established principle that the complaint need not – indeed, should not – plead detailed evidence.[34] It also severely penalizes plaintiffs for not yet knowing information that, in a securities fraud action, typically is within the exclusive possession of defendants prior to discovery. Many cases properly hold that securities fraud plaintiffs need not plead such information as long as the complaint alleges facts that support the reasonableness of scienter allegations made on information and belief. *E.g.*, *Rombach*, 355 F.3d at 175 n.10; *In re Rockefeller Center*, 311 F.3d at 216; *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 351 (5th Cir. 2002).

Motions to dismiss are decided based only on the complaint's allegations, documents incorporated by reference in the complaint, and matters as to which the court may take judicial notice. 5B Charles A. Wright & Arthur R. Miller, *Federal Practice and Procedure* § 1357 (3d ed. 2004). Therefore, any judicial surmise concerning possible exculpatory information would occur without any factual record. How, for example, is a district judge looking at a complaint to know whether it contains the fanciful "strategic ambiguity" complained of by petitioners (Pet. Br. at 38-39) if the judge lacks a factual record to show what information was left out? Resorting to information that historically has not been considered on a motion to dismiss would conflict with the

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[34] *E.g.*, *Conley*, 355 U.S. at 47; *Ottmann*, 353 F.3d at 350 n.8; *In re Cabletron Sys.*, 311 F.3d 11, 33 (1st Cir. 2002).

language of the PSLRA itself, which requires only that "the complaint" state facts giving rise to a strong inference of scienter. Speculation in the absence of a proper factual record should not deprive plaintiff of favorable inferences he or she otherwise would receive. Petitioners' approach would foster subjective and disparate rulings on motions to dismiss across the country, undermining the PSLRA's express purpose to promote uniform application of the securities laws. *See, e.g.*, H.R. Rep. No. 104-369, at 41; *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 107 (2d Cir. 2001).

Petitioners' disparagement of the complaint in this action highlights their true objective, which is to terminate securities cases regardless of their merit. For example, despite highly particularized factual allegations, based on investigation and numerous sources, showing petitioners made deceptive statements that plainly were at odds with what they knew about the serious problems clouding Tellabs' prospects, petitioners argue that respondents did not plead such evidentiary details as the precise dates of reports — facts that respondents could not rationally be expected to obtain until after discovery. Even if the information were available, petitioners are demanding a level of evidentiary detail not required at the pleading stage since the days of common law procedure.

As another example, petitioners contend that the court below should have rejected any inference for respondents because petitioners made certain disclosures in which they modified their guidance. The complaint's particularized allegations showed that those disclosures were themselves incomplete and deceptive. Moreover, there is no factual record on which the district judge could reach any informed conclusion as to why the modified guidance on which petitioners rely was given or what impact that guidance should have on the scienter issue.[35]

[35] Even without regard to Notebaert's scienter, the complaint adequately alleges knowledge on the part of many other members of (Cont'd)

Similarly, petitioners and supporting *amici* seek to raise the pleading standard to unreasonable heights by suggesting that, absent allegations of motive to engage in fraud, there can be no strong inference of scienter. Courts have recognized repeatedly that proof of motive is not necessary for § 10(b) liability. *See, e.g., In re HealthCare Compare Corp. Secs. Litig.*, 75 F.3d 276, 283 (7th Cir. 1996); *First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1320 (5th Cir. 1977); *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 362 (2d Cir. 1973).[36]

Petitioners' reliance on this Court's decisions in *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986), and *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752 (1984), is misplaced. In both cases, the courts had the benefit of a very full factual record. Indeed, in *Monsanto*, this Court

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Tellabs senior management, whose state of mind would be imputed to Tellabs for § 10(b) purposes. There is no requirement that the person with culpable knowledge be a named defendant. *See, e.g., City of Monroe Employees Retirement Sys. v. Bridgestone Corp.*, 387 F.3d 468, 508 & n.35 (6th Cir. 2004).

[36] Petitioners' suggestion that Notebaert had no incentive to misrepresent Tellabs' performance and prospects defies common sense. The public revelation that its most important product, 5500, was not selling and that one of its most important new products, 6500, was not ready surely would have jeopardized the Company's standing in a highly competitive and troubled market. That Notebaert, whose livelihood and business reputation depended on his Company's success, desired to protect Tellabs and himself from the adverse effects of publicizing those problems makes complete sense. A jury also might consider that the Company's Chairman and five other insiders personally profited from the artificial inflation of Tellabs stock by selling, during the Class Period, almost 150,000 shares for proceeds of over $8 million. (JA 148-52, ¶¶144-45) None of the insiders *purchased* any Tellabs stock during the Class Period (other than certain options exercised at substantially below-market prices, that were then immediately sold for a substantial profit). (JA 148-52, ¶¶144-45) No inference adverse to respondents should be drawn from the fact that Notebaert did not risk his reputation, property, or liberty by not engaging in illegal selling of Tellabs stock.

upheld the jury verdict as reasonable even though some of the plaintiff's evidence was "ambiguous." 465 U.S. at 765-66.

Matsushita is consistent with a proscription against weighing. In that case, this Court considered the propriety of granting summary judgment on an antitrust claim alleging a predatory pricing conspiracy. The evidence offered by plaintiffs suggested either a conspiracy that would result in higher, not lower, prices, or conduct as consistent with legitimate price competition as with unlawful behavior. 475 U.S. at 594. Thus, *Matsushita*, far from condoning a weighing of inferences, concluded that summary judgment was appropriate because "the conduct does not give rise to [any] inference of conspiracy." *Id.* at 596-97.[37] Ultimately, this Court concluded there were no reasonable inferences to be drawn in plaintiffs' favor, not that any such inferences were outweighed by inferences favoring defendants.[38] That understanding of *Matsushita* was clarified

[37] Moreover, central to the *Matsushita* decision was a concern that price-cutting to increase business could be pro-competitive, yet prone to be misconstrued as collusive. 475 U.S. at 593-94.

[38] *Pennsylvania R.R. Co. v. Chamberlain*, 288 U.S. 333 (1933), a FELA action, and *Gunning v. Cooley*, 281 U.S. 90 (1930), relied upon by amicus New England Legal Foundation, are consistent with *Matsushita* in that when evidence indicates wrongful behavior and perfectly lawful behavior in equal measure, it is not on its own probative. As explained in *Liberty Lobby*, 477 U.S. at 251, insufficient evidence supported a jury's finding in the *Chamberlain* plaintiff's favor. *Chamberlain*'s precedential value may have been compromised by later cases such as *Lavender v. Kurn*, 327 U.S. 645, 653 (1946), which recognized that "a measure of speculation and conjecture" by the jury may be necessary to choose "the most reasonable inference" from the evidence presented. "Only when there is a complete absence of probative facts to support the conclusion reached does a reversible error appear." *Id.* at 653. *See, e.g., Preston v. Safeway Stores, Inc.*, 163 F. Supp. 749, 752-53 (D.D.C. 1958) (noting that *Lavender* overruled *Chamberlain* "*sub silentio*"), *aff'd*, 269 F.2d 781 (D.C. Cir. 1959). In *Gunning*, the Court confirmed: "[w]here uncertainty as to the existence of negligence

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in *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451 (1992), in which this Court explained: "*Matsushita* demands only that the nonmoving party's inferences be reasonable in order to reach the jury, a requirement that was not invented, but merely articulated, in that decision. If the plaintiff's theory is economically senseless, no reasonable jury could find in its favor, and summary judgment should be granted."[39]

The PSLRA did not create a regime requiring plaintiffs to prove their case on the face of the complaint.[40] That would be contrary to Congress' express commitment to protecting shareholders and the integrity of the securities markets. Requiring courts to speculate as to how much weight competing strong inferences should be given — in the face of a legitimate inference for the plaintiff — does just that and is likely to result in dismissal of many meritorious fraud claims: "In this era of corporate scandal . . . we are cautious to raise the bar of the PSLRA any higher than that which is required under its mandates. The District Court's failure to accept Plaintiffs' allegations as true and construe them in the light most favorable to Plaintiffs does just that." *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920, 946 (9th Cir. 2003).

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arises from a conflict in the testimony or because, the facts being undisputed, fair-minded men will honestly draw different conclusions from them, the question is not one of law but of fact to be settled by the jury." 281 U.S. at 94.

[39] In *Eastman Kodak*, this Court ignored inferences raised by the moving party favorable to it on summary judgment, 504 U.S. at 486; instead it framed its examination of the record solely in terms of the reasonableness of the non-moving party's inferences. *Id.* at 471 ("[d]oes Kodak's theory describe actual market behavior so accurately that respondents' assertion of Kodak market power in the aftermarkets, if not impossible, is at least unreasonable?"). Because those inferences were not unreasonable, summary judgment was denied. *Id.* at 477.

[40] "The PSLRA did not . . . purport to move up the trial to the pleadings stage." *Kinder-Morgan*, 340 F.3d at 1101.

II. THE UNPRECEDENTED AND INCONSISTENT STANDARDS OF STRONG INFERENCE URGED BY PETITIONERS AND SUPPORTING *AMICI* CONTRAVENE THE SEVENTH AMENDMENT

Any interpretation of the PSLRA's strong inference standard requiring more than an inference strong enough to support a reasonable jury's finding that defendant acted with scienter violates the jury trial guarantee.[41] Respondents' proposed pleading standard is consistent with the proof standard plaintiffs must satisfy at trial as well as with the Seventh Amendment standard this Court has articulated as to when a fact issue properly can be withdrawn from the jury.

In *Herman & Maclean v. Huddleston*, 459 U.S. 375 (1983), this Court held that preponderance of the evidence is the governing proof standard in cases under § 10(b). *Id.* at 390. If the PSLRA pleading requirement places a higher burden on plaintiffs than preponderance, a district court would have to dismiss a complaint even though its allegations, if proved, would be sufficient for a jury to find for the plaintiff. This result is likely to occur if the Court adopted the Solicitor General's "high likelihood" standard, which clearly raises the pleading bar higher than preponderance. Similarly, petitioners' conveniently constructed notion that the complaint must be one that "meaningfully tends to exclude innocent possibilities," and that the complaint should be dismissed if it "leaves out details that would clarify whether the identified conduct was either innocent

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[41] Because respondents offer a construction of "strong inference" that avoids this constitutional problem, this construction should be adopted by this Court. *Curtis v. Loether*, 415 U.S. 189, 192 n.6 (1974). This argument is properly before the Court because, as the Seventh Circuit recognized, Seventh Amendment concerns must be considered in interpreting the PSLRA "strong inference" standard. *See Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374, 379-80 (1995) (argument not waived, even though expressly disclaimed in the courts below, because the argument "is fairly embraced within the question set forth in the petition for certiorari").

or culpable" (Pet. Br. at 38) raises a substantial prospect that complaints would be dismissed even though their factual allegations might convince a reasonable jury applying a preponderance standard to find for plaintiff.

A. The Seventh Amendment Mandates The Substance Of The Jury Trial Be Preserved; The Jury Must Be Allowed To Be The Fact-Finder

This Court has long recognized: "Maintenance of the jury as a fact-finding body is of such importance and occupies so firm a place in our history and jurisprudence that any seeming curtailment of the right to a jury trial should be scrutinized with utmost care." *Dimick v. Schiedt*, 293 U.S. 474, 486-87 (1935) (Stone, J., dissenting). And, as then Justice Rehnquist wrote, dissenting, in *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 343-44 (1979), jury trial is "an important bulwark against tyranny and corruption, a safeguard too precious to be left to the whim of the sovereign," "not animated by a belief that use of juries would lead to more efficient judicial administration," but rather a belief that "juries represent the layman's common sense, the 'passional elements in our nature,' and thus keep the administration of law in accord with the wishes and feelings of the community. O. Holmes, Collected Legal Papers 237 (1920)." *Id.* at 343-44.

Analysis of whether a procedure violates the Seventh Amendment looks to whether that procedure obstructs or interferes with the jury's substantive role as fact-finder. *See Dimick*, 293 U.S. at 491 (Seventh Amendment forbids procedures that "curtail the function of the jury to decide questions of fact as it did before the adoption of the Amendment" (Stone, J., dissenting)).

Even when upholding procedural changes in jury trial practice, this Court has protected the fact-finding role of the jury. Thus, in *Ex parte Peterson*, 253 U.S. 300, 311 (1920), the Court approved the use of a court-appointed auditor to hold a hearing to determine issues in dispute, so long as "[t]he parties

will remain as free to call, examine, and cross-examine witnesses as if the report had not been made." The Court held that the Seventh Amendment "does not prohibit the introduction of new methods for determining what facts are actually in issue" so long as "the right of trial by jury be not obstructed, and ... the ultimate determination of issues of fact by the jury be not interfered with." *Id.* at 309-10. In *Gasoline Prods. Co. v. Champlin Refining Co.*, 283 U.S. 494, 500-01 (1931), the Court allowed a partial new trial even though at common law any new trial would be on all issues, because a partial new trial did not obstruct the jury's role as ultimate fact-finder. In *Baltimore & Carolina Line, Inc. v. Redman*, 295 U.S. 654, 659 (1935), the Court found a judgment notwithstanding the verdict to be constitutionally acceptable, so long as its use was limited to cases in which a party's evidence was legally insufficient to support a jury verdict in the nonmovant's favor. And in *Galloway v. United States*, 319 U.S. 372 (1943), in the course of upholding the directed verdict procedure, the Court recognized, "the Seventh Amendment. . . *guaranty requires that the jury be allowed to make reasonable inferences from facts proven in evidence having a reasonable tendency to sustain them.*" *Id.* at 395-96.[42] Again, as in *Peterson*, *Gasoline Prods.*, and *Redman*, the procedure in *Galloway* was found to be constitutional because it did not encroach upon the jury as ultimate fact-finder unless, as a matter of law, the non-moving party could not support its claim.

Thus, this Court always has recognized that a plaintiff's right to a jury on the facts can be limited only if "'the evidence, with all the inferences that justifiably could be drawn from it,

[42] The comment in *Galloway* that "[t]he jury was not absolute master of fact in 1791," 319 U.S. at 390, cited *Rex v. Paine*, 5 Mod. 163 (K.B. 1792), and *Folkes v. Chadd*, 3 Doug. 157 (K.B. 1782). That these cases do nothing more than apply evidentiary rules demonstrates that *Galloway*'s comment meant simply that the right to a jury trial must be considered in light of the rules of evidence, *not* that a court had wide latitude to substitute itself as fact-finder. *See Galloway*, 319 U.S. at 390 n.22.

does not constitute a sufficient basis for a verdict for the plaintiff . . . so that such a verdict, if returned, would have to be set aside.'" *Gunning*, 281 U.S. at 93-94 (citing cases). Only the jury can be the fact-finder unless a court concludes that as a matter of law there is only one possible jury determination. *See Baltimore & Ohio R.R. Co. v. Groeger*, 266 U.S. 521, 524 (1925).

The great respect this Court has accorded the jury trial guarantee was demonstrated in the seminal decisions in *Beacon Theatres, Inc. v. Westover*, 359 U.S. 500 (1959), *Dairy Queen, Inc. v. Wood*, 369 U.S. 469 (1962), and *Ross v. Bernhard*, 396 U.S. 531 (1970), by contracting the equity jurisdiction concepts of irreparable injury and inadequacy of the legal remedy and thereby dramatically expanding the issues that are constitutionally jury triable. And, not surprisingly, this philosophy has been incorporated into Federal Rule 50(a)(1) (directed verdict granted if "there is no evidentiary basis for a reasonable jury to find for [a] party on [an] issue"). *See* Fed. R. Civ. P. 50, Advisory Committee Notes on 1991 Amendments ("The expressed standard makes clear that action taken under the rule is a performance of the court's duty to assure enforcement of the controlling law *and is not an intrusion on any responsibility for factual determinations conferred on the jury by the Seventh Amendment or any other provision of federal law.*").

Liberty Lobby, 477 U.S. at 247-48, similarly applies this standard to Rule 56 motions, holding that disputes "over facts that might affect the outcome of the suit" "such that a reasonable jury could return a verdict for the nonmoving party" are inappropriate for summary judgment. Moreover, the Court confirmed that "[if] reasonable minds could differ as to the import of the evidence, however, a verdict should not be directed." *Id.* at 250-51.

B. The Jury Trial Right Applies To Actions Under § 10(b)

The Seventh Amendment applies to this action, which seeks damages to remedy violations of statutory rights analogous to common law claims tried to a jury in 1791, *i.e.* fraud. Statutory policies, such as "expedition," fear of jury bias, or a desire to screen out meritless or marginal cases, "are insufficient to overcome the clear command of the Seventh Amendment." *See Curtis v. Loether*, 415 U.S. at 198 (civil rights). Indeed, the Seventh Amendment applies and that "command" trumps even a statutory indication that Congress did not intend a jury trial right to attach to a particular matter. *City of Monterey v. Del Monte Dunes*, 526 U.S. 687 (1999) (42 U.S.C. § 1983 takings claim); *Feltner v. Columbia Pictures Television, Inc.*, 523 U.S. 340 (1998) (copyright); *Pernell v. Southall Realty*, 416 U.S. 363 (1974) (landlord-tenant). *See also* 9 Wright & Miller, Federal Practice & Procedure § 2302.2 (2d ed. Supp. 2006).

Congress' power to create, modify, or eliminate private rights of action under the Exchange Act does not empower Congress to impair the jury trial guarantee as long as those rights exist, *cf. Granfinanciera, S. A. v. Nordberg*, 492 U.S. 33, 52-53 (1989) (Congress may not assign fact-finding in private litigation to an administrative tribunal), as they do. Moreover, the preponderance proof burden for § 10(b) claims (*see Huddleston*) was not elevated by the PSLRA.[43] Thus whether petitioners' proposed pleading standard would be appropriate *had* Congress raised the standard of proof is hypothetical and irrelevant.[44]

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[43] *See Green Tree*, 270 F.3d at 654 n.7 (citing cases from nine courts of appeal). *Geffon v. Micrion Corp.*, 249 F.3d 29 (1st Cir. 2001), cited by the Solicitor General, is silent as to the standard of proof for scienter, and merely reaffirms that circuit's precedent that allegations of motive and opportunity do not alone suffice for a reasonable inference of scienter. *Id.* at 36.

[44] For the same reason, *amicus* Washington Legal Foundation's citation to *Liberty Lobby*, 477 U.S. at 252, 254-56, for the proposition

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The Solicitor General and petitioners' other supporting *amici* argue that the Seventh Amendment may apply at trial or on summary judgment, but not at the pleading stage. This argument seriously misreads their cited authorities. For example, the comment in *Scheuer*, 416 U.S. at 236, that "the issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support its claims" simply indicated that, consistent with *Conley v. Gibson*, 355 U.S. 41 (1957), a Rule 12(b)(6) motion merely tests whether the plaintiff has *stated* a cognizable right to relief. In the same paragraph of *Walker v. New Mexico Southern Pacific R.R. Co.*, 165 U.S. 593, 596 (1897), as the comment that the Seventh Amendment "does not attempt to regulate matters of pleading" is the statement: "[To preserve the substance of the Amendment] ... requires that questions of fact in common law actions shall be settled by a jury, and that the court shall not assume directly or indirectly to take from the jury or to itself such prerogative." The observation in *Galloway*, 319 U.S. at 390 n.22, that the Seventh Amendment does not "require adherence to the common-law system of pleading," cites the *Peterson*, *Gasoline Prods.*, and *Dimick* cases, as discussed in Point II(A), and *Walker* discussed above in this paragraph, none of which suggest that obstructing the jury's substantive role as fact-finder is permissible.[45] The observation in *Baltimore & Carolina Line, Inc. v. Redman*, 295 U.S. at 657, that "mere matters of form or procedure" are not affected by the Seventh Amendment's

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that "courts must take into account the legal rules and standards of proof governing the claims at issue, including any elevated standards imposed upon the party bearing the ultimate burden of proof at trial" (Brief at 17) has no bearing. Congress has not enacted any 'elevated standards" of proof.

[45] *Galloway* also cites *Capital Traction Co. v. Hof*, 174 U.S. 1 (1899), which merely holds that a civil action brought before a justice of the peace in the District of Columbia is triable by a jury, even though at common law such an action would not be jury triable. *Hof* thus protects the substantive role of the jury as fact-finder.

protections was conditioned on furthering the Amendment's "aim" that "issues of law are to be resolved by the court and issues of fact are to be determined by the jury under appropriate instructions by the court." The comment in *Pease v. Rathbun-Jones Engineering Co.*, 243 U.S. 273, 278 (1917), that "the constitutional right of trial by jury presents no obstacle" to granting summary judgment was based on a specific issue, having nothing to do with this case's Seventh Amendment inquiry, regarding the defendant surety's "acquiescence" to proceeding in equity on a damage claim against him.

Other than these disembodied comments,[46] petitioners and supporting *amici* offer no substantive basis for concluding that the respect for jury trials accorded on summary judgment and at trial should not apply with equal force on a motion attacking a PSLRA pleading, when the plaintiff has set forth sufficient facts to support a reasonable jury verdict in its favor or scienter. Indeed, should this Court accept petitioners' and supporting *amici*'s argument, it is difficult to imagine any articulable constitutional limit on what allegations or claims could be stricken on a motion to dismiss, no matter how meritorious a jury might find them as a matter of proof. If the district judge can make factual determinations or weigh the merits of allegations or competing inferences on a motion to dismiss, pleading motions may serve as an avenue for evading and ultimately eroding Seventh Amendment protections.

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[46] Finally, *amicus* Chamber of Commerce's reliance on 8 Moore's Federal Practice § 38.12 ignores that treatise's clarification at subsection [1] that "[a] great many procedural processes have the effect of limiting or even diminishing the jury's prerogatives, yet they have passed constitutional muster, and their use has been approved, *so long as the court adheres to the standards provided in the Rules and shaped by court decisions, limiting the power of the courts to invade the province of the jury.*"

C. Characterizing The PSLRA's Strong Inference Requirement As Merely A Heightened Pleading Standard Or A "Legal" Standard Does Not Immunize It From Seventh Amendment Scrutiny

Consistent with the Seventh Amendment, procedural rules or statutes may impose pleading standards that require heightened detail on the factual matters ultimately to be adjudicated at trial, as with Rule 9(b)[47] and the PSLRA itself, or the clarification of ambiguities,[48] as with Rule 12(e), particularly when the ambiguity suggests that the pleader's case might fail as a matter of law.[49] Likewise, rules requiring verification or certification of allegations by oath or otherwise, as with Rule 11, are acceptable to the extent they guard against frivolous claims.[50] Indeed, the authorities relied upon by petitioner and supporting *amici* (*see* notes 47 - 50) support dismissal only in

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[47] *See Swierkiewicz*, 534 U.S. at 512-13: *Leatherman*, 507 U.S. at 168. *See also Jones*, 127 S. Ct. at 921 (noting Congress' power to require particularized pleading of exhaustion of remedies, as failure to exhaust was grounds for substantive dismissal of claim).

[48] *See Fidelity & Deposit Co. v. United States*, 187 U.S. 315, 322 (1902) (defendant required, but failed, to state his defense "in precise and distinct terms") (citations omitted).

[49] *See Stuart v. United States*, 85 U.S. 84, 87-88 (1873) (claim dismissed when plaintiff was required to prove that Native Americans who stole his cattle were "enemies" of the United States but pled ambiguously that Native Americans were "hostile," without clarifying whether they were hostile to plaintiff specifically or hostile to the United States generally); *United States v. Linn*, 42 U.S. 104, 113-14 (1843) (defendant unsuccessfully tried to avoid liability on joint note by claiming that the note was altered after his signature; defendant failed to claim who altered it, that the obligee knew of the alteration, or that the defendant himself did not know that the note had been altered"); 1 Chitty & Chitty, *A Treatise on the Parties to Actions and on Pleading* 236 (6th ed. 1836) (case could be dismissed for failure to allege elements of claim adequately, even though plaintiff conceivably could win at trial with greater detail).

[50] *See Ex parte Peterson*, 253 U.S. at 311 (requiring plaintiff to take an oath as to his allegations).

these situations. That is far different from a construction of the strong inference requirement that demands more in the plaintiff's complaint than is needed to warrant the case's submission to the jury.

Petitioners and supporting *amici* cannot evade Seventh Amendment scrutiny by conclusorily characterizing the sufficiency of scienter allegations as legal, not factual. Whether a complaint presents enough to establish the requisite scienter inference is a factual matter based on an evaluation of what the pleading alleges actually happened. "At a minimum, the jury is master of 'historical' fact." Arthur R. Miller, *The Pretrial Rush to Judgment: Are The "Litigation Explosion," "Liability Crisis" and Efficiency Cliches Eroding Our Day in Courts and Jury Trial Commitments?*, 78 N.Y.U.L. Rev. 982, 1083 (2003). A determination of scienter involves a classic evaluation of the "mainsprings of human conduct," something this Court has referred to at least twice as appropriately within the jury's competence. *Markman v. Westview Instruments, Inc.*, 517 U.S. 370, 389 (1996) (quoting *Commissioner v. Duberstein*, 363 U.S. 278, 289 (1960)).

Unless a court concludes as a matter of law that no reasonable jury could find scienter by a preponderance of the evidence, the matter must be left to the jury. The more demanding pleading standards advanced by petitioners and supporting *amici* for a PSLRA motion to dismiss — effectively a dispositive motion — require the court to act as fact-finder on a merits issue in contravention of Seventh Amendment principles.[51]

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[51] Specifically, *amicus* Washington Legal Foundation states (Br. at 19) a complaint can be dismissed under the PSLRA if "legally insufficient under the governing standard," but the Foundation fails to recognize that the "governing standard" is the preponderance standard that has not been altered. In any event, characterization of the PSLRA strong inference determination as a question of law rather than a question of fact would lead to eradication of Seventh Amendment rights in a

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D. Weighing Inferences Is A Constitutionally Protected Jury Function

Petitioners propose that the PSLRA requires the court to "consider and weigh all the allegations of the complaint, along with all other materials properly before it, *including facts that support an inference of innocence*." (Pet. Br. at 17) But to be consistent with the jury trial guarantee, if plaintiffs have pleaded facts from which a jury reasonably could find fraudulent intent, all weighing must end.[52]

This Court has established in various contexts that a court must draw all inferences in favor of a party opposing a dispositive motion and it cannot determine "[i]ssues that depend on the credibility of witnesses, [or] the effect or weight of evidence." *Gunning*, 281 U.S. at 94. *See also Galloway*, 319 U.S. at 396 ("[The Seventh Amendment's] guaranty requires that the jury be allowed to make reasonable inferences from facts proven in evidence having a reasonable tendency to sustain them."). *Tennant v. Peoria & Pekin Union Railway Co.*, 321 U.S. 29, 35 (1944), is in accord:

> It is not the function of a court to search the record for conflicting circumstantial evidence in order to take the case away from the jury on a theory that the proof gives equal support to inconsistent and uncertain inferences. The focal point of judicial review is the reasonableness of the particular

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wide range of substantive areas, by inviting the enactment of "legal" standards that could prevent meritorious claims or defenses from reaching a jury. *Cf. Granfinanciera.*

[52] Petitioners' supporting *amici* articulate standards that transgress the Seventh Amendment, by proposing formulations that improperly would require a court to consider inferences unfavorable to the plaintiff, weigh them against legitimate inferences for the plaintiff, and dismiss the complaint if the court believes the inference for defendant is more persuasive even if the inferences favoring plaintiff reasonably could support a jury's verdict for it.

> inference or conclusion drawn by the jury. It is the jury, not the court, which is the fact-finding body. . . . The very essence of its function is to select from among conflicting inferences and conclusions that which it considers most reasonable.

These principles were reaffirmed in *Liberty Lobby*, 477 U.S. at 255, and *Reeves*, 530 U.S. at 150-51, discussed in Point I(F). Also, as discussed in Point I(H), *Matsushita* is consistent with these authorities and provides no support for petitioners and supporting *amici*.

CONCLUSION

For the foregoing reasons, the decision of the court of appeals should be affirmed.

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No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD C. NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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REPLY BRIEF

Respondents read the heightened pleading provision of the Private Securities Litigation Reform Act ("Reform Act") to defeat itself. The Reform Act does not require facts merely giving rise to "an inference" or a capacious "reasonable inference." It expressly requires a "strong inference." Yet respondents not only propose a "reasonable inference" standard, Resp. Br. 24, they sap any potential vigor from even that standard by urging that plaintiff-friendly presumptions apply to motions to dismiss governed by the Reform Act. However well suited such presumptions are for the open-door policy of notice pleading, they find no support in the structure and purpose of the Reform Act. Whether worded in terms of a heightened "strength" requirement, or viewed as a narrowed range of "reasonableness," it is clear that Congress sought to ensure that claims based on weak inferences are dismissed.

Unlike respondents' approach, petitioners' standard—that a plaintiff must "plead specific facts that, if proven to be true, cogently demonstrate a substantial claim as to scienter that meaningfully tends to exclude innocent possibilities," Pet. Br. 16—gives content to the word "strong." As importantly, petitioners advocate three guiding principles that equip a court to police securities fraud complaints as Congress intended. First, the reference to whether "the complaint" alleges facts giving rise to a "strong inference" of scienter means that a court must take into consideration *all* the facts alleged and inferences to be drawn therefrom, including taking account of those that weaken any inference of scienter. Second, allegations that are ambiguous as to scienter, *i.e.*, allegations that merely suggest a possibility of scienter but which, by themselves, provide no more reason to believe that scienter was present than absent, cannot create a "strong inference" of scienter. Moreover, when a plaintiff strategically pleads critical facts ambiguously, those facts cannot create a strong inference. Third, the presence or

absence of any motive to engage in fraud also bears on the strength of any inference of scienter, with the absence of any evident motive necessitating that the other circumstantial evidence be that much stronger for a "strong inference" to exist. These principles reflect the core of this case. The Seventh Circuit's decision is fatally flawed because it fails meaningfully to apply any of them.

Moreover, even though the core of respondents' own interpretation of the "strong inference" standard is the reasonableness of the inference that Notebaert acted with fraudulent intent, respondents never describe the supposedly rational connection from the facts relied upon by the Seventh Circuit to the inferred conclusion. Indeed, respondents simply ignore the Seventh Circuit's effort to bridge the gap between the facts pled and Notebaert's scienter, opting instead for an empty assurance that the connection exists. Resp. Br. 25. Claiming that they are entitled to benefit from their own ambiguity, respondents offer a contentless "reasonableness" standard that is as flexible as the imagination of plaintiffs' counsel, and that ignores the congressional policy to deprive plaintiffs of access to costly and disruptive discovery when they allege only weak inferences of scienter.

The pleading principles advanced by petitioners provide the critical content to the "strong inference" standard that respondents' argument lacks. Applying these principles to the allegations of this complaint requires reversal and will provide strong guidance to lower courts that frequently face complaints relying on similar allegations.

1. Respondents begin with an attempt to place the Reform Act's pleading requirements within the rubric of traditional standards and presumptions applicable to motions to dismiss. Even after the Reform Act, respondents argue, plaintiffs still "need not plead detailed evidence" and "the allegations of the complaint should be construed favorably to the pleader." Resp. Br. 17.

It is hard to imagine what more Congress might say in the Reform Act to make it clear that a departure from such traditional rules is required. To begin with, the entire purpose of the relevant Reform Act provision is to ensure that a plaintiff pleads at this initial stage detailed, *i.e.*, "particular[ized]," facts giving rise to a "strong inference" of scienter. 15 U.S.C. § 78u-4(b)(2). And it is precisely because Congress intended an early evaluation of the adequacy of the asserted factual basis for a claim of scienter that the Reform Act affirmatively forbids recourse to discovery unless the facts demonstrate a "strong inference" at the outset. *Id.* § 78u-4(b)(3)(B). Moreover, not only did Congress expressly require "particularity," it required that when a plaintiff alleges on information and belief that a statement is misleading, the plaintiff must "state with particularity *all* facts on which that belief is formed." *Id.* § 78u-4(b)(1) (emphasis added). These significant and detailed changes were "enacted as an exception, not just to state an already existing rule." *Stone* v. *INS*, 514 U.S. 386, 397 (1995).

Likewise, the general rule requiring courts to construe the allegations of a complaint entirely in favor of the plaintiff must be modified if the requirement that "the complaint" support a "strong inference" of scienter is to have any meaning. If everything is to be construed favorably to plaintiff, regardless how strong or weak the inference, then the "strong inference" standard is nothing more than a requirement to allege facts that give rise to a bare possibility of scienter. *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002); *Pirraglia* v. *Novell, Inc.*, 339 F.3d 1182, 1187-88 (10th Cir. 2003). But Congress passed the Reform Act to put an end to weakly-grounded securities fraud suits. Pet. Br. 26-31. Indeed, it is precisely because Congress wished to alter the loose and forgiving approach to a plaintiff's pleading of scienter that the "strong inference" requirement was adopted. *Id.* at 29. It makes no sense to interpret a statute that requires a plaintiff to plead facts giving rise to a "strong inference" of

scienter as nonetheless allowing a complaint to survive based on nothing more than indulgent constructions of allegations which presume that discovery may yield evidence to support a weak claim.

Yet that is precisely what respondents advocate, arguing, for example, that pleading ambiguities should give rise to plaintiff-favorable inferences. Resp. Br. 33-35. Nor does it advance the inquiry to say that only "reasonable inferences" should be construed in a plaintiff's favor. This merely shifts the problem to a different level. In fact, what is "reasonable" in this context is itself a function of the "strong inference" requirement. *Infra* at 15-17. And that is why most courts applying the Reform Act have refused to credit certain common weak inferences, *e.g.*, that because of his or her position, a defendant "must have known" what was occurring throughout the company. Pet. Br. 40.

2. Despite their assertions that the Reform Act does not alter the mode of analysis applicable to a motion to dismiss, respondents ultimately articulate a proposed standard that is clearly more demanding than that generally applied to a Rule 12(b)(6) motion. Respondents ask this Court to hold that "[a]n inference [is] 'strong' if the particularized allegations support a reasonable conclusion that the defendant *probably*—i.e., *more likely than not*—had scienter." Resp. Br. 24 (emphases added). Respondents assert that a textual parsing of the "strong inference" standard "connotes probability and tendency." *Id.* at 25.

At this level of abstraction, there might appear to be less distance between respondents' and petitioners' standards than respondents' heated rhetoric would suggest. Like respondents, petitioners propose a standard that speaks in terms of probabilities and tendencies. A plaintiff must "plead specific facts that, if proven to be true, cogently demonstrate a substantial claim as to scienter that meaningfully *tends* to exclude innocent possibilities." Pet. Br. 16 (emphasis added). And a fact does not "tend to exclude" innocence if it is

equally consistent with innocence and culpability, *i.e.*, if there is no "probability." *Id.* at. 37-41.

Notwithstanding their verbal similarity, respondents and petitioners fundamentally diverge with respect to how these standards work. Respondents take issue with each of the three guiding principles petitioners advanced. See *id.* at 33-41. The heart of the dispute between the parties resides at this level, including how these principles should be applied to the facts alleged, which also goes to the core of the Seventh Circuit's error in this case.

a. Though respondents advocate requiring a court to evaluate whether it is reasonable to conclude that the facts in the complaint show that it is more likely than not that a defendant acted with scienter, they offer a one-sided method that leaves a court unable to deny that an available inference of scienter is anything but strong. Respondents would constrain a court to consider only the inferences of scienter that favor the plaintiff. They would thus have the court shut its eyes to any inferences that weaken the inference of scienter, even to innocent possibilities that are evident on the face of the complaint. See Resp. Br. 18. By divorcing the plaintiff-favorable inference from its context, and excluding any consideration of negative inferences, respondents seek to create an inappropriate and artificial "vacuum" in which an objective evaluation of the strength of an inference cannot take place. *Gompper*, 298 F.3d at 896; *Pirraglia*, 339 F.3d at 1187; *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 51 (1st Cir. 2005).[1] Respondents' view contradicts the plain language of the Reform Act, which requires a court to review "the complaint" to determine whether the "strong inference" standard is met, not merely some parts of the complaint.

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[1] As discussed in petitioners' brief, the Seventh Circuit created just such a vacuum by reviewing the allegations before it only for inferences that supported scienter, divorcing them from the full context that weakened that inference. Pet. Br. 46-48.

Indeed, the outcome of respondents' "more likely than not" scienter test becomes foreordained because no defendant-favorable inferences can even be considered; once a court perceives *any* basis for concluding the defendant acted with scienter, the inquiry ends.

The appropriate test considers *all* the facts and inferences available from *all* the allegations and other material properly before the court. This inclusive approach flows from what both parties' standards share in common: a court's need to evaluate whether the record on a Rule 12(b)(6) motion, taking the allegations as true, would support a valid scienter finding. A "reasonable" conclusion that a defendant "probably" acted with scienter—respondents' stated test—is not one that ignores substantial countervailing facts and innocent explanations, or fails to take into account critical gaps. A "reasonable" conclusion is based on all the facts. *Matsushita Elec. Indus. Co.* v. *Zenith Radio Corp.*, 475 U.S. 574, 586-87 (1986). And when the available inferences are evaluated in light of the full record, the innocent inference may appear "at least equal to the [culpable] inference ..., thus negating the probative force" of the culpable inference. *First Nat'l Bank of Ariz.* v. *Cities Serv. Co.*, 391 U.S. 253, 280 (1968). In such a circumstance, no reasonable "probability" of scienter can be said to exist.

This is not to say that a complaint need rule out every *conceivable* innocent explanation to give rise to a "strong inference" of scienter. "Inferences must be reasonable and strong—but not irrefutable." *Helwig* v. *Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (*en banc*). Neither do petitioners argue that a court should choose among competing "strong" inferences, and credit only the "strongest." The point is that consideration of innocent explanations and countervailing facts is part of the process of determining whether an inference of scienter is "strong" in the first place. Respondents concede as much when they endorse the Tenth Circuit's standard, which expressly states that a plaintiff must

"'plead[] facts with particularity that, *in the overall context of the pleadings, including potentially negative inferences,* give rise to a strong inference of scienter.'" Resp. Br. 29 (quoting *Pirraglia*, 339 F.3d at 1188 (emphasis added)). When the pleaded facts, taken as a whole, do not meaningfully tend to exclude innocent explanations, they do not demonstrate that culpability can reasonably be found to be more likely than not, and the inference of scienter is not "strong."

b. The treatment of ambiguous pleading is the second way that respondents' approach to the strong inference standard differs substantially from that of petitioners. Petitioners identified two different kinds of pleading ambiguities: (1) strategic ambiguity that leaves out details that would clarify whether conduct was innocent or culpable, and (2) allegations of conduct that are as consistent with innocence as culpability. Pet. Br. 38-41. Both kinds of ambiguous pleading fail to give rise to a "strong inference" of scienter because, in not distinguishing culpable from innocent conduct, they give the court (and a factfinder) no basis for concluding that the culpable conclusion is more probable.

Respondents assert that strategic ambiguity is a "fanciful" notion, and that there is no reason to require a complaint to provide "details that would clarify whether defendants' conduct was either innocent or culpable." Resp. Br. 33-34. They argue that any acknowledgment of innocent explanations that emerge from the ambiguity in a pleading would involve impermissible "judicial surmise ... without any factual record ... to show what information was left out[;]" they describe the process as "[s]peculation" based on "information that historically has not been considered on a motion to dismiss." *Id.* at 34-35.

These claims of impermissible speculation are precisely upside-down. A court evaluating whether ambiguities in a pleading render any inference of scienter too weak to satisfy the "strong inference" standard is not speculating regarding what other evidence may exist, nor is it considering any

information beyond that properly before it. The plaintiff, as master of the complaint, controls the degree of ambiguity in the pleading. And if the plaintiff fails to fill in critical, clarifying details, then the plaintiff has not pled "facts" sufficient for a "strong inference," or even with the requisite "particularity." Under these circumstances, it is the plaintiff that is requesting the benefit of mere speculation, and the inference of scienter is correspondingly weakened. While the facts alleged in the complaint must be taken as true, "[i]t is not ... proper to assume that [a plaintiff] can prove facts that it has not alleged." *Associated Gen. Contractors of Cal., Inc.* v. *California State Council of Carpenters*, 459 U.S. 519, 526 (1983).

The complaint in this case provides particularly dramatic examples. Respondents chose to include within their definition of "channel stuffing" lawful discounting to encourage sales. JA 110, ¶ 62. And while respondents alleged that Notebaert knew of "channel stuffing," they chose *not* to specify the precise conduct of which he was allegedly aware—*i.e.*, was it legitimate discounting or illegitimately sending unordered products to customers? JA 111, 157, ¶¶ 67, 156. The district court even pointed this ambiguity out to respondents when dismissing an earlier complaint without prejudice. Pet. App. 74a. Yet respondents *still* chose not to delete any reference to legitimate conduct from their "channel stuffing" allegation, and refused to provide any detail regarding which type of "channel stuffing" Notebaert allegedly participated in. Petitioners are not engaged in "self-serving speculation," Resp. Br. 12, when they point out that plaintiffs' own allegations are constructed in a way that is perfectly consistent with innocence.

Likewise, respondents assert that it is wrong to require clarifying detail such as the precise dates of reports because that is the kind of information that is likely unable to be known until they can take discovery. *Id.* at 35. But here the precise dates of reports are critical to distinguish legitimate

conduct from culpable conduct because the reports are the basis of the claim that Notebaert supposedly knew his statements were false when made. See Pet. App. 23a-24a. A complaint missing the critical facts connecting a defendant's false statement to his knowledge of its falsity does not give rise to a "strong inference" of scienter. Moreover, under the Reform Act, the argument that the plaintiff cannot plead a critical fact, but hopes to learn the truth through discovery, has no place; the Reform Act forecloses access to discovery until the plaintiff is able to demonstrate that the factual basis for a "strong inference" of scienter already exists. 15 U.S.C. § 78u-4(b)(3)(B).

Respondents, consistent with their claim to all plaintiff-friendly constructions, believe ambiguous pleading should not be disfavored. Resp. Br. 35 (arguing that ambiguity "should not deprive plaintiff of favorable inferences he or she would otherwise receive"). Ambiguity, under their endlessly malleable "reasonable inference" standard, comes without risk to plaintiffs because a court must treat that which is imprecise as if it were clear and favorable to the plaintiff's assertion of scienter.

But encouraging ambiguous pleading is the opposite of what the Reform Act was intended to accomplish. Ambiguous allegations produce precisely the kind of "weak" inference that the Reform Act sought to eliminate. By insisting on particularity in pleading and imposing a "strong inference" standard, the text of the Reform Act makes clear that Congress sought to increase the confidence a court has that it is allowing only cases with substantial merit to move forward into costly and burdensome discovery. A complaint that states critical facts ambiguously provides no such confidence.

Yet again, respondents ultimately run from their own position. Respondents concede that "when evidence indicates wrongful behavior and perfectly lawful behavior in equal measure, it is not on its own probative." Resp. Br. 37 n.38 (citing *Pennsylvania R.R.* v. *Chamberlain*, 288 U.S. 333, 339-

40 (1933)). That concession is fatal to the complaint. The channel stuffing allegations and the allegations of various reports regarding customer demand do not, absent critical clarifying details, point either toward or away from a conclusion that Notebaert acted with scienter. "One can tell the [culpable] instance from the wholly [innocent] one only by reference to some further circumstance." *Virginia* v. *Black*, 538 U.S. 343, 385 (2003) (Souter, J., concurring in part and dissenting in part). If, as here, the allegations fail to distinguish culpable from innocent conduct, what has been stated fails to give rise to a "strong inference" of scienter.

c. The third significant difference between respondents' and petitioners' approaches is the treatment of the presence or absence of allegations of motive. Respondents incorrectly claim that petitioners seek to require a plaintiff to plead adequate allegations of motive to give rise to a strong inference of scienter. Resp. Br. 36. In fact, petitioners merely argued that the presence or absence of plausible motive allegations impacts the strength of any inference of scienter. Pet. Br. 36-37. Motive is part of the full package of facts that, taken together, a court should evaluate. Thus, while its presence is not a *sine qua non*, its absence or implausibility is telling. This view has never been controversial. The Second Circuit, for example, has held that when a complaint fails to plead allegations of motive, the strength of other circumstantial allegations of scienter "must be correspondingly greater." *Kalnit* v. *Eichler*, 264 F.3d 131, 142 (2d Cir. 2001); see *Cities Serv.*, 391 U.S. at 287 (holding that an "inference of conspiracy sought to be drawn ... does not logically follow" in the absence of any motive for participation). That is all petitioners advocate.

3. Petitioners' approach to facts and inferences pointing away from scienter, ambiguous pleading, and the presence or absence of motive are all well rooted in a substantial body of caselaw. Respondents assert that petitioners' approach is "unprecedented," Resp. Br. 34, without discussing the cases

upon which petitioners relied. See Pet. Br. 35-40. Those cases belie respondents' argument that the courts have been and should be uncritically accepting of inferences claimed to be favorable to plaintiffs, even in the face of contrary inferences and ambiguity, and even when no allegations of motive are present. See, *e.g.*, *Greenstone* v. *Cambex Corp.*, 975 F.2d 22, 26-27 (1st Cir. 1992) (Breyer, J.).

The prior decisions supporting petitioners' view include those of the Second Circuit, which respondents urge has provided the standard for what constitutes a "strong inference." In assessing whether a plaintiff has alleged facts that give rise to a strong inference of scienter, the Second Circuit considers the record as a whole, including inferences that undercut scienter. *E.g.*, *Rombach* v. *Chang*, 355 F.3d 164, 176 (2d Cir. 2004) (noting that "the allegation that defendants behaved recklessly is weakened by their disclosure of certain financial problems prior to the deadline to file [the company's] financial statements"); *San Leandro Emergency Med. Group Profit Sharing Plan* v. *Philip Morris Cos.*, 75 F.3d 801, 814 (2d Cir. 1996) (affirming dismissal even though one defendant sold stock because "the fact that other defendants did not sell their shares during the relevant period sufficiently undermines plaintiffs' claim"); *Acito* v. *IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995) (same). Further, as noted above, the Second Circuit takes the presence or absence of motive into account. *Kalnit*, 264 F.3d at 142. The Second Circuit also disdains ambiguous pleading, refusing, for example, to draw a strong inference of scienter from ordinary conduct that is as consistent with innocence as with guilt, such as the desire to maintain the appearance of corporate profitability and the desire to maintain a high stock price in order to increase executive compensation or prolong the benefits of holding a corporate office. *E.g.*, *Novak* v. *Kasaks*, 216 F.3d 300, 307 (2d Cir. 2000).

All of this renders academic respondents' claim that the legislative history demonstrates that Congress intended to

adopt what the Second Circuit had been doing. Even if that were Congress's intent, respondents' complaint would still fail for the reasons discussed in petitioners' opening brief. Still, that was not Congress's intent. Although Congress borrowed the phrase "strong inference" from the Second Circuit, Congress made clear that it did not "intend to codify the Second Circuit's case law interpreting this pleading standard." H.R. Conf. Rep. No. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740; see also S. Rep. No. 104-98, at 15 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 694 (same); Private Securities Litigation Reform Act of 1995—Veto Message from the President of the United States, 141 Cong. Rec. H15214, H15215 (daily ed. Dec. 20, 1995) (noting that the conferees "make crystal clear" their intention to raise the pleading standard above prior Second Circuit law). Nothing in the subsequent legislative history from the Securities Litigation Uniform Standards Act of 1998 is inconsistent with the Reform Act legislative history. Congress merely reiterated that the "strong inference" standard was "based upon" the Second Circuit's standard. H.R. Conf. Rep. No. 105-803, at 15 (1998).

Finally, the fact that petitioners' operative principles are well rooted in prior decisions shows that respondents and their *amici* are engaged in unconstrained exaggeration when they suggest that petitioners' standard is near impossible to meet. Resp. Br. 23-24, 34-35. Numerous cases, including those within the Second Circuit, have allowed complaints to survive based on allegations that petitioners recognize satisfy the strong inference standard. *E.g.*, *Novak*, 216 F.3d at 311-12; *Suez Equity Investors, L.P.* v. *Toronto-Dominion Bank*, 250 F.3d 87, 100 (2d Cir. 2001).

4. Respondents' final arrow in their quiver is the Seventh Amendment, an argument they raise here for the first time. Joined by various *amici*, respondents urge that petitioners' standard would violate the Seventh Amendment to the extent it would impose a stricter standard for pleading a securities

fraud claim than is imposed to determine whether the plaintiff's evidence of fraudulent intent would survive a motion for summary judgment or can survive a post-trial motion. Resp. Br. 40, 47. Respondents expressly rest their Seventh Amendment argument on the proposition that the passage of the Reform Act should not alter this Court's selection of a preponderance-of-the-evidence standard of proof with respect to the judicially implied private right of action under Section 10(b). *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 387-91 (1983); Resp. Br. 43.

Whether the passage of the Reform Act alters the premises underlying this Court's adoption of the preponderance standard need not be decided[2] because the Seventh Amendment surely allows a court ruling on a motion to dismiss to consider the whole complaint, treat ambiguous pleading as insufficient, and recognize that motive is pertinent to the strength of an inference of scienter. Moreover, respondents' Seventh Amendment argument is built on a false premise. Petitioners do not urge this Court to apply a higher standard for pleading a securities fraud claim than would apply at summary judgment or post-trial. In fact, the same principles discussed above that limit the range of permissible

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[2] The question whether the judicially adopted preponderance standard should be reconsidered is not "irrelevant" if this Court concludes that the Reform Act raises Seventh Amendment concerns. Resp. Br. 43. In that event, to avoid the constitutional issue, this Court could raise the judicially created proof standard if that outcome proves more consistent with Congressional intent. Acting without any congressional guidance, this Court in *Huddleston* determined that the risk of litigation error should be shared equally by both private securities fraud plaintiffs and defendants. 459 U.S. at 390-91. Congress has now made clear that the risks of error to defendants and the marketplace were too great under the prior regime, warranting enhanced standards including a "strong inference" requirement. Pet. Br. 26-30. Under these circumstances, a compelling argument could be made that a "clear and convincing" standard better captures the policies of the Reform Act than a preponderance standard.

inferences at the pleading stage should operate at the proof stage as well.[3]

For example, ambiguous allegations lacking critical, clarifying detail are not sufficient to warrant a trial. Even respondents acknowledge that, "[c]onsistent with the Seventh Amendment, procedural rules or statutes may impose pleading standards that require ... the clarification of ambiguities ... particularly where the ambiguity suggests that the pleader's case might fail as a matter of law." Resp. Br. 46 (footnotes omitted).[4] That is precisely *petitioners'* point. Congress has required "the clarification of ambiguities" for securities fraud pleadings because too many baseless claims were being filed. And, even at trial, when there is a gap in the connection between the evidence and the inferred conclusion necessary to support a judgment, a court should grant judgment as a matter of law. *Galloway* v. *United States*, 319 U.S. 372, 386-96 (1943) (directing verdict for defendant where continuous and permanent mental insanity was at issue, and plaintiff presented evidence showing insanity at outset of the relevant period and at its conclusion, but left a gap in the middle which could not be filled by inference).

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[3] Respondents and some *amici* have also argued that petitioners' standard violates the Seventh Amendment to the extent it requires a judge to evaluate the credibility of witnesses. Petitioners have never suggested that a court should assess the credibility of witnesses. It is, however, entirely appropriate for a court to demand allegations that demonstrate that there is reason to believe an anonymous confidential source has first-hand knowledge of the matters attributed to him or her, and is not simply repeating hearsay or engaging in speculation. *In re Cabletron Sys., Inc.*, 311 F.3d 11, 29-30 (1st Cir. 2002).

[4] Respondents concede that traditional common law pleading rules dismissed claims based on ambiguities without running afoul of the Seventh Amendment. Pet. Br. 39-40, 42, and Resp. Br. 46 n.49 (discussing *United States* v. *Linn*, 42 U.S. (1 How.) 104 (1843), and *Stuart* v. *United States*, 85 U.S. (18 Wall.) 84 (1873)).

Likewise, a statutory claim may not survive summary judgment based on "highly ambiguous evidence" concerning conduct that "'arise[s] in the normal course of [legitimate] business.'" *Monsanto Co.* v. *Spray-Rite Serv. Corp.*, 465 U.S. 752, 763 (1984); see also *Matsushita*, 475 U.S. at 596-97 (facts do not give rise to an inference of conspiracy when "conduct is consistent with other, equally plausible explanations"); *Cities Serv.*, 391 U.S. at 280 (same). For example, in *Matsushita*, this Court reversed a decision allowing a claim to proceed past the summary judgment stage in part because the court of appeals "did not consider whether it was as plausible to conclude that [the defendants'] price-cutting behavior was independent and non-conspiratorial." 475 U.S. at 581. And in *Cities Service*, this Court affirmed the grant of summary judgment in favor of the defendant because the evidence of participation in the alleged conspiracy was undermined by "contrary evidence" that suggested nonculpable reasons for the defendants' refusal to deal with the plaintiff that were "at least equal to the inference" of conspiracy. 391 U.S. at 277, 280. The absence of any plausible motive to engage in the allegedly unlawful conspiracy also played a significant role in this Court's decisions to preclude a trial in both cases. *Matsushita*, 475 U.S. at 596 ("[l]ack of motive bears on the range of permissible conclusions that might be drawn from ambiguous evidence"); *Cities Serv.*, 391 U.S. at 287 (because plaintiff "is unable to point to any benefits to be obtained by Cities from refusing to deal with him ... the inference of conspiracy ... does not logically follow").

A jury should, of course, be left free to draw "legitimate" and "justifiable" inferences from the record. *Anderson* v. *Liberty Lobby, Inc.*, 477 U.S. 242, 255 (1986). But, as the cases just discussed demonstrate, the range of such legitimate inferences is informed by the underlying substantive law. In those cases, an inference that did not meaningfully exclude innocent possibilities was held not to be "reasonable." Just as

this Court has narrowed the range of permissible inferences at the proof stage to advance the policies of the antitrust laws, the "strong inference" standard is, in effect, an explicit substantive direction from Congress that the courts should narrow the range of permissible inferences to advance the policies of the securities laws.

In the antitrust cases, this Court considered defendant-friendly inferences, including the absence of motive, and refused to allow ambiguous evidence to go to trial because it was concerned that if a judgment could be based on nothing more than "mistaken [jury] inferences" drawn from facts that are consistent with lawful, pro-competitive behavior, then private antitrust enforcement would chill the very conduct it was supposed to encourage. *Matsushita*, 475 U.S. at 594.[5] In securities cases, Congress concluded that allowing pleaded claims based on weak inferences to proceed to discovery was deterring the free and open disclosure of information regarding publicly traded companies, which is precisely what

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[5] Respondents emphasize that in *Matsushita* this Court was ruling based on a full factual record, and that this Court was concerned that the conduct at issue could be "pro-competitive, yet prone to be misconstrued as collusive." Resp. Br. 36, 37 n.37. Petitioners agree. And the way *Matsushita* approached the summary judgment record, by respondents' own admission, raises no Seventh Amendment concern, so approaching a pleading the same way also must raise no Seventh Amendment concern. Likewise, the fact that *Matsushita* concluded that the inference of conspiracy was not "reasonable" is no objection to petitioners' reading of the case. *Id.* at 37. Petitioners' point is that *Matsushita* narrowed the range of "reasonable" inferences to preserve the underlying policies of the antitrust laws. Contrary to respondents' suggestion, *id.* at 37-38, this Court did not read *Matsushita* differently in *Eastman Kodak Co.* v. *Image Technical Services, Inc.* 504 U.S. 451 (1992). To the contrary, *Kodak* reaffirmed that in *Matsushita* this Court was concerned that "mistaken inferences" would chill the conduct that the antitrust laws were designed to protect. *Id.* at 478. The allegations in *Kodak* did not raise that concern, so, this Court concluded, *Matsushita* was inapposite. *Id.*

the securities laws were supposed to encourage.[6] Pet. Br. 28-29. This is a substantive judgment well within the bounds of congressional authority to determine the scope of private claims under its statutes. And for the same reason that Congress would want a court to conclude that weak inferences are insufficient for pleading purposes, weak inferences should also be considered insufficient for proof purposes.

5. The abstract, semantic formulations of a "strong inference" standard take on life only through application. As one court has noted, "general standards offer little insight ... [i]t is the actual facts of ... securities fraud cases that provide the most concrete guidance as to the types of allegations required to meet" the pleading standard. *Novak*, 216 F.3d at 308. And, in many ways, it is the Seventh Circuit's approach to application that best illuminates its error. This Court's decision will best guide the lower courts to a uniform, national standard by explaining why this complaint fails.

There is a single issue here: Notebaert's scienter. As the Seventh Circuit recognized, the Reform Act makes clear that allegations of scienter must be defendant-specific. Pet. App. 21a-22a. And the Seventh Circuit ruled that the claims against both Notebaert and, derivatively, the Company could proceed based on Notebaert's alleged scienter alone.[7]

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[6] Respondents and their *amici* dispute that the problem of securities fraud strike suits, which spawned the Reform Act, remains. Resp. Br. 21-24. For present purposes it is sufficient to note that, over the past 10 years, all of which are *post*-Reform Act, 2,465 issuers have been named as defendants in securities fraud class actions out of approximately 6000 companies listed on the four major U.S. exchanges. Comm'n on the Regulation of U.S. Capital Mkts. in the 21st Century, *Report and Recommendations* 30 (Mar. 2007), *available at* www.capitalmarketscommission.com/portal/capmarkets/default.htm.

[7] In a footnote, unsupported by any citation, respondents incorrectly argue that Tellabs' scienter may be based on "knowledge on the part of many other members of Tellabs' senior management." Resp. Br. at 35

As petitioners demonstrated in their opening brief, Pet. Br. 43-50, the Seventh Circuit identified the specific allegations that it believed supported a "strong inference" of scienter. Petitioners demonstrated that the Seventh Circuit's analysis ignored critical facts, including public announcements downgrading expectations in the midst of an alleged fraud inflating those expectations; ignored the absence of any plausible motive for Notebaert to engage in fraud; and relied on strategically ambiguous allegations regarding when Notebaert supposedly learned of weakening demand for Tellabs' products, whether Notebaert knew of any illegitimate channel stuffing, and whether Notebaert was aware of problems in the development and shipping of the TITAN 6500 during the class period.

Respondents disregard the Seventh Circuit's analysis and its express reliance on certain specified allegations. Indeed, they almost entirely sidestep their obligation to point to facts in their complaint which establish *Notebaert's* scienter. Instead, respondents indiscriminately refer to a broad array of allegations pertaining to a variety of defendants (against whom Section 10(b) claims were dismissed without appeal), Resp. Br. 2-12, and some of which even the Seventh Circuit explicitly acknowledged could not support a strong inference of scienter. For example, respondents repeat allegations regarding supposedly fictitious sales and backdated orders, *id.* at 10, 12, but the Seventh Circuit concluded that those allegations were insufficiently particularized to satisfy the Reform Act's standard, Pet. App. 13a. In addition,

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n.35. As noted in the text, the Seventh Circuit rejected this very argument, and there is no basis for this Court to reach it given that it has not been briefed by either party. In any event, respondents are wrong. Under both the common law and Section 10(b) law before and after the Reform Act, "a principal may not be subject to liability for fraud if one agent makes a statement, believing it to be true, while another agent knows facts that falsify the other agent's statement." Restatement (Third) of Agency § 5.03 cmt. d(2) (2006); *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 366-67 (5th Cir. 2004) (collecting cases).

respondents repeat allegations concerning alleged weakening of demand for Tellabs' products dating back into the middle of 2000, *e.g.*, Resp. Br. 2, even though the Seventh Circuit concluded that "it was not until March 2001 that the TITAN 5500's declining status was obvious." Pet. App. 24a.

It should be no surprise that respondents fail to address the specific allegations relied upon by the Seventh Circuit, and instead adopt a kitchen-sink approach. When this Court pushes past respondents' distractions,[8] and focuses on the facts purporting to support an inference of scienter as to Notebaert, the proper resolution of this case becomes straightforward. Respondents say nothing to dispute that their pleading is ambiguous in critical respects, either as to channel stuffing, the timing of reports regarding weakening demand, or the nature of Notebaert's alleged knowledge of unspecified "problems" with the TITAN 6500. They instead resort to claiming the benefit of ambiguity. Resp. Br. 33-35. It is critically important that this Court make clear that allegations of this sort are insufficient to create a "strong inference" under any formulation.

Respondents' effort to explain why they believe they have adequately alleged motive also fails, and is an exemplar of the type of "weak" inference that should not be credited because

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[8] Two of respondents' distractions warrant a brief response. First, respondents claim that petitioners have no basis to assert that Notebaert's statement regarding "end user demand for services," JA 34, refers to customers of Tellabs' customers. Resp. Br. 7, n.6. But Notebaert says in the very next sentence that Tellabs' products "help[] our carrier customers meet this demand," JA 34, which makes indisputably clear that he is referring to the demand of Tellabs' customers.

Second, respondents also confuse matters in seeking to downplay the undisputed fact that Tellabs' revenues increased by 21% in the first quarter of 2001 over the same quarter in the previous year. Pet. Br. 47. Respondents present data for the same periods with respect to net earnings, not revenue. And respondents present revenue figures for different quarters, not the same quarters over consecutive years. Resp. Br. 9 n.10.

it can be drawn in any circumstance. Respondents assert that Notebaert's "livelihood and business reputation depended on his Company's success." Resp. Br. 36 n.36. Putting aside that no such claim is made in the complaint, this is precisely the kind of universally present motive that courts refuse to treat as adequate. "[I]f scienter could be pleaded on that basis alone, virtually every company in the United States that experiences a downturn in stock price could be forced to defend securities fraud actions." *Acito*, 47 F.3d at 54. Even putting that problem aside, respondents' claim that Notebaert's job and reputation gave him some incentive merely to delay revealing the "true facts" regarding Tellabs' performance for a limited period of time makes no sense. There is no plausible motive when all that is alleged is a "short respite from an inevitable day of reckoning." *Shields* v. *Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994).

Respondents also try to counter certain of the circumstances that significantly undermine respondents' claim of scienter. Respondents argue that the statements modifying Tellabs' guidance downward during the class period were "incomplete and deceptive." Resp. Br. 35. That they were "incomplete" is just another way of saying that Tellabs eventually did not meet even those modified projections. That they were "deceptive" is an unsupported conclusion about Notebaert's mental state at the time he announced those revisions. In fact, as petitioners pointed out, Notebaert's mid-class period revisions were actually *greater* than the amounts the complaint alleges were projected in the various reports of weakening demand, which form the primary basis for the claim of Notebaert's scienter. Pet. Br. 47-48.

CONCLUSION

The decision of the Seventh Circuit should be reversed.

Respectfully submitted,

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TELLABS, INC., ET AL., PETITIONERS

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONERS

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QUESTION PRESENTED

Whether, and to what extent, a court must consider or weigh competing inferences in determining whether a securities fraud complaint has "state[d] with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," as required by the Private Securities Litigation Reform Act of 1995.

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In the Supreme Court of the United States

No. 06-484

TELLABS, INC., ET AL., PETITIONERS

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES
AS AMICUS CURIAE SUPPORTING PETITIONERS

INTEREST OF THE UNITED STATES

The United States, through the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC), administers and enforces the federal securities laws. The issue in this case concerns the interpretation of the heightened pleading requirement for state of mind in private securities fraud actions. Meritorious private actions are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by DOJ and the SEC. At the same time, Congress has recognized a potential for such actions to be abused in ways that impose substantial costs on companies that have fully complied with the applicable laws. The United States has a strong interest in seeing that the principles applied in private actions promote the

purposes of the securities laws, and has previously participated as an amicus curiae in cases involving those principles.

STATEMENT

1. Petitioner Tellabs, Inc., manufactures equipment used in fiber-optic networks; respondents are persons who purchased Tellabs stock between December 11, 2000, and June 19, 2001. Petitioner Richard C. Notebaert served as chief executive officer and president of Tellabs during the relevant period. Respondents allege that, during that period, Notebaert and other Tellabs executives "falsely reassured public investors, in a series of statements * * *, that Tellabs was continuing to enjoy strong demand for its products and earning record revenues." "In truth," respondents further allege, "Tellabs' performance was being adversely affected by the same difficult telecommunications business environment that its competitors had been facing." J.A. 94, 95, 98; Pet. App. 1a, 30a.

As is relevant here, respondents more specifically allege that Notebaert made four categories of false or misleading statements during the relevant period. J.A. 113-144. First, Notebaert allegedly made statements indicating that demand for the TITAN 5500, Tellabs' flagship networking device, was continuing to grow, when demand for that product was in fact flagging. Pet. App. 10a-12a, 48a-50a. Second, Notebaert allegedly made statements indicating that the TITAN 6500, Tellabs' next-generation networking device, was available for delivery, and that demand for that product was strong and growing, when the product was not in fact ready for delivery and demand was weak. *Id.* at 12a-13a, 51a-53a. Third, Notebaert allegedly falsely repre-

sented Tellabs' financial results for the fourth quarter of 2000 (and, in connection with those results, sanctioned the practice of "channel stuffing," under which Tellabs flooded its customers with unwanted products). *Id.* at 13a-14a, 55a-57a. Fourth, Notebaert allegedly made a series of overstated revenue projections, when demand for the TITAN 5500 was drying up and production of the TITAN 6500 was behind schedule. *Id.* at 14a-16a, 45a.

Starting in March 2001, Tellabs made progressively more cautious statements about its projected sales. On June 19, 2001, the last day of the relevant period, Tellabs disclosed that demand for the TITAN 5500 had significantly dropped, and considerably lowered its revenue projections for the second quarter of 2001. The following day, the price of Tellabs stock, which had reached a high of $67.125 during the period, dropped to a low of $15.87. Pet. App. 3a-5a, 39a.

2. Respondents filed a class action against petitioners and other Tellabs executives in the United States District Court for the Northern District of Illinois. In their complaint, as amended, respondents alleged, *inter alia*, that defendants had engaged in securities fraud in violation of Section 10(b) of the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, and that the individual defendants were derivatively liable as "controlling persons" under Section 20(a) of the 1934 Act, 15 U.S.C. 78t(a). J.A. 167-171.

Under Section 21D(b)(2) of the 1934 Act, which was added by the Private Securities Litigation Reform Act of 1995 (Reform Act or PSLRA), Pub. L. No. 104-67, § 101(b), 109 Stat. 737, a private securities fraud complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the

required state of mind." 15 U.S.C. 78u-4(b)(2). Defendants moved to dismiss the complaint on the ground, *inter alia*, that respondents had failed to meet that heightened pleading standard.

The district court dismissed the complaint without prejudice. Pet. App. 80a-117a. As is relevant here, the court noted that, while respondents had contended that "the Individual Defendants knew facts or recklessly disregarded information at their disposal that contradicted their public statements," they had failed to "individualize their allegations as to each of these Defendants, as they must." *Id.* at 113a. The court further noted that "[c]onclusory allegations of reckless disregard are insufficient to raise a strong inference of scienter" for purposes of the Reform Act. *Ibid.*

3. Respondents filed a second amended complaint in which they included additional allegations concerning defendants' mental state. J.A. 152-160. Defendants moved to dismiss the complaint on the ground, *inter alia*, that respondents had still failed to meet the Reform Act's heightened pleading standard.

The district court again dismissed the complaint, this time with prejudice. Pet. App. 28a-79a. The court held that, as to the four categories of statements discussed above, respondents had sufficiently alleged that the statements were misleading. *Id.* at 45a-46a, 48a-59a. As to those categories of statements, however, the court held that respondents had insufficiently alleged the requisite state of mind. *Id.* at 46a-48a, 59a-74a. At the outset, the court noted that "[respondents] again lump many of their scienter allegations together with broad statements regarding 'Defendants' or the 'Individual Defendants.'" *Id.* at 60a. The court reasoned that

"these allegations alone are insufficient to establish scienter under the PSLRA." *Id.* at 61a.

With regard to petitioner Notebaert more specifically, the district court first observed that "[respondents] do not allege that CEO Notebaert sold stock during the Class Period." Pet. App. 62a. The court then reasoned that, while respondents had alleged that Notebaert attended various meetings with Tellabs employees and participated in regular phone calls concerning the status of Tellabs' products, "[t]hese allegations support that Notebaert was active in Tellabs' business as one would expect, but they do not establish scienter." *Id.* at 73a. The court explained that "[respondents] do not disclose any details regarding what Notebaert allegedly learned during these calls or meetings that support an inference of scienter." *Ibid.* The court determined that respondents' allegations concerning "channel stuffing" were also insufficient, because "there is nothing inherently wrong with several of [respondents'] channel stuffing allegations." *Id.* at 74a. Overall, the court noted, "[respondents] rely on group pleading allegations about Notebaert's position in the company and general conclusions concerning his knowledge of the allegedly fraudulent activities without providing particulars to reinforce their general conclusions." *Ibid.*; see *id.* at 48a. "Such allegations," the court concluded, "fail to meet the mandates of the PSLRA." *Id.* at 74a.

4. The court of appeals reversed as to the claims against petitioners, and remanded for further proceedings. Pet. App. 1a-27a.[1] The court of appeals first held

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[1] The court of appeals also reversed as to claims against other Tellabs executives under Section 20(a) of the 1934 Act, 15 U.S.C. 78t(a), and Section 20A, 15 U.S.C. 78u-1. Those claims are derivative of the Section 10(b) and Rule 10b-5 claims against petitioners.

that, with regard to all four of the categories of statements discussed above, respondents had sufficiently alleged that the statements were misleading. *Id.* at 8a-16a. Unlike the district court, however, the court of appeals held that respondents had sufficiently alleged that Notebaert (and thus, by imputation, Tellabs itself) had acted with the requisite state of mind. *Id.* at 16a-26a.

a. As a preliminary matter, the court of appeals recognized that the Reform Act "unequivocally raise[d] the bar for pleading scienter" by requiring plaintiffs to "plead[] sufficient facts to create 'a strong inference' of scienter." Pet. App. 18a. But the court contended that "Congress did not, unfortunately, throw much light on what facts will suffice to create such an inference." *Ibid.* In the court of appeals' view, "the best approach is for courts to examine all of the allegations in the complaint and then to decide whether collectively they establish such an inference." *Id.* at 20a.

The court of appeals then observed that "[a]nother concern, independent from the question of what type of information will support a finding of scienter, is the degree of imagination courts can use in divining whether a complaint creates a 'strong inference.'" Pet. App. 20a. The court of appeals considered, but rejected, a standard under which a court would consider whether the inference of scienter was the "strongest" inference that could be drawn from the alleged facts, on the ground that such a standard "could potentially infringe upon plaintiffs' Seventh Amendment rights." *Ibid.* "Instead of accepting only the most plausible of competing inferences as sufficient at the pleading stage," the court held, "we will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." *Ibid.* By

contrast, "[i]f a reasonable person could not draw such an inference from the alleged facts, the defendants are entitled to dismissal," because "the complaint would fail as a matter of law to meet the requirements of [the Reform Act]." *Id.* at 21a.

Applying that standard, and holding that "plaintiffs must create [the required] inference with respect to each individual defendant in multiple defendant cases," Pet. App. 22a, the court of appeals determined that the complaint had sufficiently alleged that Notebaert possessed the requisite state of mind with regard to each of the four categories of alleged misstatements. *Id.* at 21a-26a. As to the statements concerning the TITAN 5500, the court concluded, based on "the significance of the TITAN 5500 and the number of reports suggesting that it was in trouble," that "[respondents] have provided enough for a reasonable person to infer that Notebaert knew that his statements were false." *Id.* at 23a. As to the statements concerning the TITAN 6500, the court reasoned that, "[i]f it is true that the TITAN 6500 was not in fact available during the class period, it is hard to accept that Notebaert's statements were simply honest mistakes." *Id.* at 24a-25a. As to Tellabs' financial results, the court determined that respondents had "allege[d] sufficient facts to suggest that Notebaert was aware of the channel stuffing" and "therefore knew that Tellabs had exaggerated its fourth quarter 2000 revenues." *Id.* at 25a. Finally, as to the revenue projections, the court reasoned that those projections "rest[ed] on the company's statements that its products were doing better than they actually were," and that "the scienter for those alleged misrepresentations serves as sufficient circumstantial evidence of scienter here." *Ibid.*

SUMMARY OF ARGUMENT

Congress enacted the Private Securities Litigation Reform Act of 1995 in order to curtail abusive practices that undermine the beneficial purposes of private securities litigation. As part of that effort, Congress amended the Securities Exchange Act of 1934 to require that a securities fraud complaint "state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind." 15 U.S.C. 78u-4(b)(2). The court of appeals erroneously diluted that requirement by holding that a securities fraud plaintiff need only "allege[] facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." Pet. App. 20a.

Before the enactment of the Reform Act, numerous lower courts, applying Rule 9(b) of the Federal Rules of Civil Procedure, held that it was insufficient for a securities fraud plaintiff merely to allege state of mind generally, and some courts held that a securities fraud plaintiff was required to allege facts that gave rise to at least a reasonable inference of the requisite mental state. The Second Circuit, however, went further and held that a securities fraud plaintiff was required to allege facts that gave rise to a *strong* inference of scienter. In enacting the Reform Act, Congress intended to impose a uniform and heightened pleading standard that built upon the Second Circuit's "strong inference" terminology.

In evaluating whether a plaintiff has alleged facts that "giv[e] rise" to a "strong inference" of scienter, a court should determine whether, taking the alleged facts as true, there is a high likelihood that the conclusion that the defendant possessed scienter follows from those facts. While it is impossible to specify with mathemati-

cal precision the degree of likelihood required for a "strong inference," both the plain language of the Reform Act and the backdrop against which it was enacted show that a "strong" inference requires something considerably more than merely a "reasonable" inference. The standard applied by the court of appeals in this case does not appear to differ materially from the "reasonable" inference standard that it (and other courts of appeals) had applied *before* the enactment of the Reform Act. Congress plainly rejected that approach in favor of a more demanding standard.

In determining whether an inference of scienter is "strong" for purposes of the Reform Act, a court will necessarily have to consider whether the facts alleged in the complaint leave open a range of non-culpable explanations for the defendant's conduct. Where the same facts simultaneously support *both* the conclusion that the defendant acted with scienter *and* the alternative conclusion that the defendant acted without scienter, the court should consider the relative strength of both inferences, because, where there is a substantial possibility that the defendant acted without scienter, the inference of scienter will not be "strong."

Finally, the Reform Act's heightened pleading requirement is consistent with the Seventh Amendment of the Constitution. Respondents did not claim that the dismissal of their complaint under the Reform Act would violate the Seventh Amendment. Even if they had, that claim would lack merit, because the Reform Act does not improperly assign to a court the jury's role of resolving genuine issues of fact. Because the court of appeals misinterpreted the Reform Act's heightened pleading standard, its decision should be vacated, and the case remanded for application of the correct standard.

ARGUMENT

IN ORDER FOR A PRIVATE SECURITIES FRAUD COMPLAINT TO SATISFY THE "STRONG INFERENCE" REQUIREMENT OF THE REFORM ACT, THERE MUST BE A HIGH LIKELIHOOD THAT THE CONCLUSION THAT THE DEFENDANT POSSESSED SCIENTER FOLLOWS FROM THE FACTS ALLEGED WITH PARTICULARITY

Section 10(b) of the Securities Exchange Act of 1934 (1934 Act) makes it unlawful to "use or employ, in connection with the purchase or sale of any security * * *, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. 78j(b). The SEC's Rule 10b-5 implements Section 10(b) by declaring it unlawful, "in connection with the purchase or sale of any security," to (a) "employ any device, scheme, or artifice to defraud"; (b) "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made * * * not misleading"; or (c) "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. 240.10b-5. Section 10(b) has been construed to afford a right of action to purchasers or sellers of securities who have been injured by its violation. See, *e.g.*, *Dura Pharmaceuticals, Inc.* v. *Broudo*, 544 U.S. 336, 341 (2005).

This Court has held that, in order to establish liability under Section 10(b) and Rule 10b-5, a private plaintiff must prove "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst* v. *Hoch-*

felder, 425 U.S. 185, 194 n.12 (1976).[2] Under the Private Securities Litigation Reform Act of 1995 (Reform Act or PSLRA), Pub. L. No. 104-67, 109 Stat. 737, a private securities fraud complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind." 15 U.S.C. 78u-4(b)(2). The question presented in this case is whether the court of appeals correctly interpreted that heightened pleading standard in concluding that respondents' allegations were sufficient.

A. Before The Enactment Of The Reform Act, Lower Courts Applied Different Pleading Standards To The Mental-State Element Of Securities Fraud

1. In an ordinary civil action, the sufficiency of a complaint is governed by Rule 8 of the Federal Rules of Civil Procedure, which requires a "short and plain statement of the claim showing that the pleader is entitled to relief." Fed. R. Civ. P. 8(a)(2). In order to satisfy that requirement, a complaint must "set forth a claim upon which relief could be granted," *Conley* v. *Gibson*, 355 U.S. 41, 45 (1957), and give the defendant "fair notice of what the plaintiff's claim is and the grounds upon which

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[2] Although this Court has reserved the question, see *Hochfelder*, 425 U.S. at 194 n.12, lower courts have consistently held that a plaintiff may meet the state-of-mind requirement by showing that the defendant acted either intentionally or recklessly (although they have articulated the degree of recklessness required in somewhat different ways). See *Ottmann* v. *Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 343 (4th Cir. 2003) (citing cases); compare, *e.g.*, *Nathenson* v. *Zonagen Inc.*, 267 F.3d 400, 408 (5th Cir. 2001) (requiring "severe recklessness," defined as "resembl[ing] a slightly lesser species of intentional misconduct"), with *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 977 (9th Cir. 1999) (requiring "deliberate recklessness," defined as "a form of intentional conduct").

it rests," *id.* at 47. That requirement, however, is "not meant to impose a great burden upon a plaintiff." *Dura Pharmaceuticals*, 544 U.S. at 347.

2. Before the enactment of the Reform Act, courts consistently held that the sufficiency of a complaint for securities fraud was governed by the more demanding standard of Rule 9(b), which applies to "all averments of fraud or mistake." Rule 9(b) provides that "the circumstances constituting fraud * * * shall be stated with particularity," but also provides that "[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally." Relying on the latter language, the Ninth Circuit held that a securities fraud plaintiff could allege the requisite state of mind "simply by saying that scienter existed," without "alleg[ing] with particularity facts giving rise to an inference of scienter." *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1546-1547 (1994) (en banc). The Ninth Circuit explained that "add[ing] new requirements to Rule 9(b)" is "a job for Congress, or for the various legislative, judicial, and advisory bodies involved in the process of amending the Federal Rules." *Id.* at 1546.

Other courts of appeals, however, "uniformly held inadequate a complaint's general averment of the defendant's [state of mind]" in securities fraud cases, *Greenstone* v. *Cambex Corp.*, 975 F.2d 22, 25 (1st Cir. 1992) (Breyer, C.J.), and instead "requir[ed] pleading of facts that would indicate scienter," *Florida State Bd. of Admin.* v. *Green Tree Fin. Corp.*, 270 F.3d 645, 655 (8th Cir. 2001). Those courts expressed concern that, unless securities fraud plaintiffs were required to do more than make conclusory allegations of scienter, they could readily allege what Judge Friendly famously called "fraud by hindsight": *i.e.*, by making "a general aver-

ment that defendants 'knew' earlier what later turned out badly." *Greenstone*, 975 F.2d at 25 (quoting *Denny* v. *Barber*, 576 F.2d 465, 470 (2d Cir. 1978)); *DiLeo* v. *Ernst & Young*, 901 F.2d 624, 627-629 (7th Cir.), cert. denied, 498 U.S. 941 (1990). Plaintiffs would thereby enable themselves to pursue discovery on unfounded claims in the hopes of "extracting undeserved settlements." *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 263 (2d Cir. 1993), cert. denied, 511 U.S. 1017 (1994); see, *e.g.*, *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1418 (3d Cir. 1997) (Alito, J.); *Romani* v. *Shearson Lehman Hutton*, 929 F.2d 875, 878 (1st Cir. 1991); *Ross* v. *A.H. Robins Co.*, 607 F.2d 545, 557 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980); see generally *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739 (1975) (noting that "[t]here has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general").

While those courts of appeals uniformly required more than the Ninth Circuit, they articulated their pleading standards differently. The Second Circuit required securities fraud plaintiffs to "specifically plead those [facts] which they assert give rise to a strong inference that the defendants had" the requisite state of mind. *Ross*, 607 F.2d at 558. In subsequent cases, the Second Circuit held that plaintiffs could meet the "strong inference" requirement in one of two ways. First, plaintiffs could "allege facts showing a motive for committing fraud and a clear opportunity for doing so." *Beck* v. *Manufacturers Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987), cert. denied, 484 U.S. 1005 (1988); see *Novak* v. *Kasaks*, 216 F.3d 300, 311 (2d Cir.) (noting that

this standard was met when defendants "benefitted in a concrete and personal way from the purported fraud"), cert. denied, 531 U.S. 1012 (2000). Second, "[w]here motive is not apparent," plaintiffs could "identify[] circumstances indicating conscious behavior by the defendant, although the strength of the circumstantial allegations must be correspondingly greater." *Beck*, 820 F.2d at 50 (citations omitted); see *Novak*, 216 F.3d at 311 (noting that this standard was met when defendants "engaged in deliberately illegal behavior," "knew facts or had access to information suggesting that their public statements were not accurate," or "failed to check information they had a duty to monitor"). Applying that standard, the Second Circuit required the dismissal of numerous securities fraud complaints. See, *e.g.*, *Kramer* v. *Time Warner Inc.*, 937 F.2d 767, 775-776 (1991); *Wexner* v. *First Manhattan Co.*, 902 F.2d 169, 172-173 (1990); *Connecticut Nat'l Bank* v. *Fluor Corp.*, 808 F.2d 957, 961-962 (1987). Accordingly, at the time the Reform Act was enacted, the Second Circuit's standard was regarded as the "most stringent" in the country. See *Nathenson* v. *Zonagen Inc.*, 267 F.3d 400, 407 (5th Cir. 2001).

Other courts of appeals "took an intermediate position" between the Second and Ninth Circuits and held that, while securities fraud plaintiffs must plead specific facts suggestive of a defendant's mental state, those facts need not give rise to a "strong" inference of the requisite state of mind. 5A Charles Alan Wright & Arthur R. Miller, *Federal Practice and Procedure* § 1301.1, at 300-302 (3d ed. 2004) (Wright & Miller). Thus, the First Circuit required plaintiffs to "set[] forth specific facts that make it reasonable to believe that defendant knew that a statement was materially false or mislead-

ing," *Greenstone*, 975 F.2d at 25; the Fifth Circuit required plaintiffs to "set forth specific facts that support an inference of fraud," *Tuchman* v. *DSC Comm'cns Corp.*, 14 F.3d 1061, 1068 (1994); and the Seventh Circuit required plaintiffs to "afford a basis for believing that plaintiffs could prove scienter," *DiLeo*, 901 F.2d at 629. Although those courts used slightly differing formulations, all of them required plaintiffs to plead facts that supported at least a reasonable inference that the defendant possessed the requisite state of mind.

B. The Reform Act Applied A Heightened Pleading Standard To The Mental-State Element Of Securities Fraud, And The Court Of Appeals Erroneously Diluted That Standard

In the Reform Act, Congress devised a heightened pleading standard for scienter that was considerably more stringent than the standard that the court below (and other courts of appeals) had applied before the Reform Act's enactment. The court of appeals therefore erred in this case by effectively adhering to its lower, pre-Reform Act standard. Instead, the court of appeals should have determined whether there was a high likelihood that the conclusion that petitioners possessed scienter followed from the particular facts alleged in respondents' complaint.

1. Congress's enactment of the Reform Act was prompted by concerns that the beneficial purposes of private securities litigation were being "undermined by * * * abusive and meritless suits," which "had become rampant in recent years." H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 31 (1995); *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Dabit*, 126 S. Ct. 1503, 1510-

1511 (2006).[3] In particular, the Reform Act was prompted by "the routine filing of lawsuits against issuers of securities * * * whenever there is a significant change in the issuer's stock price, without regard to any underlying culpability of the issuer, and with only a faint hope that the discovery process might lead eventually to some plausible cause of action." H.R. Conf. Rep. No. 369, *supra*, at 31. The legislative history noted that "[a] complaint alleging violations of the Federal securities laws is easy to craft and can be filed with little or no due diligence," S. Rep. No. 98, 104th Cong., 1st Sess. 8 (1995), while "[t]he dynamics of private securities litigation create powerful incentives to settle, causing securities class actions to have a much higher settlement rate than other types of class actions," *id.* at 6. Accordingly, the Reform Act made a number of substantive and procedural changes to the securities laws. See *Dabit*, 126 S. Ct. at 1511 (citing 15 U.S.C. 78u-4).

Of particular relevance here, the Reform Act "imposes heightened pleading requirements in [private] actions brought pursuant to § 10b and Rule 10b-5." *Dabit*, 126 S. Ct. at 1511; see *Wharf (Holdings) Ltd.* v. *United Int'l Holdings, Inc.*, 532 U.S. 588, 597 (2001). In new Section 21D(b)(1) of the 1934 Act, the Reform Act provides that, in any private securities action in which the plaintiff alleges that the defendant made a false or misleading statement, the complaint must "specify each statement alleged to have been misleading [and] the

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[3] See, *e.g.*, H.R. Conf. Rep. No. 369, *supra*, at 42 (noting that abusive securities litigation "severely affects the willingness of corporate managers to disclose information to the marketplace"); S. Rep. No. 98, 104th Cong., 1st Sess. 9 (1995) (noting that such litigation "add[s] significantly to the cost of raising capital and represent[s] a 'litigation tax' on business").

reason or reasons why the statement is misleading." 15 U.S.C. 78u-4(b)(1). Moreover, if the allegation that the statement is false or misleading is made on information and belief, the complaint must "state with particularity all facts on which that belief is formed." *Ibid.* In new Section 21D(b)(2) of the 1934 Act—the provision at issue in this case—the Reform Act further states that, in any private securities action in which the plaintiff must show that the defendant acted with a particular mental state in order to recover money damages, the complaint must, "with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind." 15 U.S.C. 78u-4(b)(2).[4]

The legislative history of the Reform Act confirms what is apparent from the terms of Section 21D(b): *viz.*, that Congress, in enacting that provision, intended to adopt "uniform and more stringent pleading requirements" for private securities fraud actions, H.R. Conf. Rep. No. 369, *supra*, at 41, and thereby "deter or at least quickly dispose of those suits whose nuisance value outweighs their merits," *Dabit*, 126 S. Ct. at 1511. The legislative history expressed concern that the application of Rule 9(b) to securities fraud actions "ha[d] not prevented abuse of the securities laws by private litigants," and noted that "the courts of appeals ha[d] interpreted Rule 9(b)'s requirement in conflicting ways, creating distinctly different standards among the circuits." H.R. Conf. Rep. No. 369, *supra*, at 41. And it expressed concern that those differences had "creat[ed] substantial uncertainties and opportunities for abuses," in light of

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[4] The Reform Act also provides for a stay of all discovery during the pendency of a motion to dismiss, subject to limited exceptions. See 15 U.S.C. 78u-4(b)(3)(B).

the potential for forum shopping in securities fraud actions. S. Rep. No. 98, *supra*, at 4.

It is clear, therefore, that, in adopting Section 21D(b)(2), Congress was reacting to the various court of appeals decisions articulating differing standards for pleading scienter in securities fraud cases (and to the continuing abuses under those standards). By using the "strong inference" standard, Congress rejected both the standard of the Ninth Circuit, which allowed securities fraud plaintiffs simply to state that scienter existed, and the "intermediate" standard of other circuits, which required plaintiffs to plead facts that supported at least a reasonable inference of scienter. Instead, Congress built upon the Second Circuit's "strong inference" terminology and added various other pleading requirements, resulting in a statute that was "intend[ed] to *strengthen* existing pleading requirements." H.R. Conf. Rep. No. 369, *supra*, at 41 (emphasis added). Section 21D(b)(2) was "not intend[ed] to codify the Second Circuit's case law interpreting [its] pleading standard." *Ibid.* At a minimum, however, Section 21D(b)(2) was intended to require dismissal in any case that would have been subject to dismissal under the Second Circuit's preexisting "strong inference" standard. See *Nathenson*, 267 F.3d at 412.[5]

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[5] The Statement of Managers accompanying the Conference Committee Report on the PSLRA (and endorsed by the members of the Committee) described the "strong inference" test in these terms:

> Regarded as the most stringent pleading standard, the Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a "strong inference" of the defendant's fraudulent intent. Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard.

2. As noted above, Section 21D(b)(2) requires that a securities fraud plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind." 15 U.S.C. 78u-4(b)(2).[6] An "inference" is "[a] conclusion reached by considering other facts and deducing a logical consequence from them." *Black's Law Dictionary* 793 (8th ed. 2004). In articulating the pleading requirement in terms of "inferences," Congress "acknowledg[ed] the role of indirect and circumstantial evidence" in proving a defendant's state of mind. *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 195 (1st Cir. 1999).

In Section 21D(b)(2), however, Congress did not merely require a plaintiff to allege particular facts from which an inference of scienter *could* be drawn, but in-

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H.R. Conf. Rep. No. 369, *supra*, at 41. The courts of appeals are in disagreement as to whether the Reform Act codified the Second Circuit's explanation of the alternative *methods* by which a securities fraud plaintiff could plead scienter (*i.e.*, *either* by "alleg[ing] facts showing a motive for committing fraud and a clear opportunity for doing so" *or* by "identifying circumstances indicating conscious behavior by the defendant," *Beck*, 820 F.2d at 50), and specifically, whether a plaintiff can plead scienter solely by alleging facts showing a motive and opportunity to defraud. See *Ottmann*, 353 F.3d at 344-346 (citing cases). This case presents no question concerning the proper role of motive-and-opportunity allegations under the PSLRA, because respondents have not alleged that petitioner Notebaert had a motive and opportunity to defraud, at least as that concept was defined by the Second Circuit (*e.g.*, by alleging that Notebaert engaged in unusual trading in Tellabs stock during the relevant period).

[6] The "strong inference" requirement is also included in the Y2K Act, Pub. L. No. 106-37, § 8(d), 113 Stat. 198, which provides that, in any qualifying "Y2K action," "there shall be filed with the complaint, with respect to each element of [the] claim, a statement of the facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. 6607(d).

stead required a plaintiff to allege particular facts that "giv[e] rise" to a "strong" inference of scienter. The strength of an inference, in turn, is measured by the degree of confidence that the conclusion at issue (here, that the defendant acted with scienter) follows from the underlying facts—or, in other words, by the extent to which the underlying facts tend to establish the conclusion at issue. See, *e.g.*, James Hawthorne, *Inductive Logic* (last modified Oct. 10, 2005), in *Stanford Encyclopedia of Philosophy* (Edward N. Zalta ed., 2007) <http://plato.stanford.edu/entries/logic-inductive>.

A "strong" inference therefore exists when there is a high degree of confidence—*i.e.*, a high likelihood—that the conclusion at issue follows from the underlying facts. The ordinary meaning of the word "strong" amply confirms that interpretation. See *Black's Law Dictionary* 1423 (6th ed. 1990) (defining "strong" as "[c]ogent, powerful, forcible, forceful"); *The American Heritage Dictionary of the English Language* 1717 (4th ed. 2000) (defining "strong," with regard to an argument, as "[p]ersuasive, effective, and cogent"); 16 *The Oxford English Dictionary* 949 (2d ed. 1989) (defining "strong," with regard to an argument, evidence, or proof, as "[p]owerful to demonstrate or convince; hard to confute or overthrow"). Accordingly, in evaluating whether a plaintiff has alleged particular facts that "giv[e] rise" to a "strong" inference of scienter, a court should determine whether, taking the alleged facts as true, there is a high likelihood that the conclusion that the defendant possessed scienter follows from those facts. See, *e.g.*, *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 48-49 (1st Cir. 2005) (concluding that "a plaintiff's allegations must show a high likelihood of scienter in order to satisfy the PSLRA standard"). It is clear that a "strong"

inference requires something considerably more than merely a "reasonable," "possible," "plausible," or "marginal" inference, even if it does not require that the inference be an "ironclad" or "irrefutable" one. See *Credit Suisse*, 431 F.3d at 49, 51; *In re Cabletron Sys., Inc.*, 311 F.3d 11, 38, 40 (1st Cir. 2002); *Helwig* v. *Vencor, Inc.*, 251 F.3d 540, 551, 553 (6th Cir. 2001) (en banc), cert. dismissed, 536 U.S. 935 (2002). While it is impossible to specify with mathematical precision the degree of likelihood required under Section 21D(b)(2), "facts giving rise to a strong inference" of scienter cannot be ambiguous facts; the inference cannot be merely borderline or a close call.

The PSLRA's stringent pleading standard reflects the critical importance of the pleading stage in private securities litigation. Securities fraud plaintiffs enjoyed, and under the PSLRA continue to enjoy, considerable latitude in pleading their complaints. They choose and craft the allegations in the complaint, see, *e.g.*, *Allen* v. *WestPoint-Pepperell, Inc.*, 945 F.2d 40, 44 (2d Cir. 1991) (noting that, in ruling on a motion to dismiss, a court must confine its consideration "to facts stated on the face of the complaint, in documents appended to the complaint or incorporated in the complaint by reference, and to matters of which judicial notice may be taken"), and all of the allegations in the complaint must be accepted as true when tested by a motion to dismiss, see, *e.g.*, *Leatherman* v. *Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 164 (1993).

Congress determined, however, that the preexisting pleading standards were leading to serious abuse in the private securities litigation context, in which "nuisance filings," followed by "vexatious discovery requests" and resulting "extortionate settlements," had become "ram-

pant in recent years." *Dabit*, 126 S. Ct. at 1510-1511. Congress concluded that the costs and dynamics of private securities litigation too often caused innocent parties to settle cases for large sums without regard to the merit of the claims—without any "evidence of fraud," S. Rep. No. 98, *supra*, at 4, for which scienter is essential under Section 10(b) and Rule 10b-5. If a securities case is not dismissed at the pleading stage, the practical reality is that the defendant will usually be forced to settle and the case will never reach an adjudication on the merits. Many years of effort by courts to screen cases under Rule 9(b) had not prevented the abuses.

In sum, Congress "structur[ed] the [Reform Act] to permit the dismissal of frivolous cases at the earliest feasible stage of the litigation, thereby reducing the cost to the company, and by derivation, to its shareholders, in defending a baseless action." *Bryant* v. *Avado Brands, Inc.*, 187 F.3d 1271, 1278 (11th Cir. 1999). Enforcing the "strong inference" requirement by requiring particularized allegations that give rise to a high likelihood of scienter is thus a crucial element of the reforms enacted by Congress.

3. In this case, the court of appeals correctly recognized that the Reform Act "unequivocally raise[d] the bar for pleading scienter" by requiring plaintiffs to "plead[] sufficient facts to create a 'strong inference' of scienter." Pet. App. 18a. The court of appeals erred, however, by failing to give force to Congress' clear intent, as reflected by the text, and instead holding that a securities fraud complaint would satisfy the Reform Act's "strong inference" standard "if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." *Id.* at 20a; see *id.* at 20a-21a (noting that a complaint should be

dismissed "[i]f a reasonable person could not draw such an inference from the alleged facts"). Although the court of appeals recognized Congress's unequivocal intent to raise the bar, the court of appeals' standard appears to be equivalent to the standard that it (and some other courts of appeals) had applied *before* the enactment of the Reform Act, under which a complaint was sufficient if the plaintiff pleaded facts that supported at least a *reasonable* inference of state of mind.[7] As explained above, however, Congress's insistence on a "strong" inference of scienter plainly requires something considerably more than a "reasonable" inference (or a permissible inference by a reasonable person). The court of appeals erred in asking whether respondents had alleged facts from which an inference of scienter *could* reasonably have been drawn. Instead, the court should have determined whether, as to each false or misleading statement at issue, there was a high likelihood that the conclusion that petitioner Notebaert possessed scienter followed from the alleged facts.

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[7] By looking to the inference that a reasonable person "could" draw, the court of appeals seemingly allows as sufficient a *permissible* inference for a reasonable person, which appears to be no different from (or, if anything, less demanding than) a *reasonable* inference. The key is the relative strength of the inference required, not the nature of the person drawing the inference. Presumably, Congress and all of the courts of appeals pre- and post-Reform Act have had in mind the inference that a reasonable, as opposed to unreasonable, person would draw. The Reform Act clearly requires more than a permissible inference; it requires a strong one.

C. In Applying The Reform Act's Heightened Pleading Standard For The Mental-State Element Of Securities Fraud, A Court Must Consider Any Competing Inference Or Non-Culpable Explanations For The Defendant's Conduct

In determining whether there is a high likelihood that the conclusion that the defendant possessed the requisite state of mind follows from the facts alleged in the complaint, a court must consider other possible explanations for the defendant's conduct—or any competing inference that can be drawn from the same facts. The probabilistic inquiry required by the "strong inference" test demands as much.

1. By its terms, Section 21D(b)(2) requires a court to determine whether the plaintiff has alleged particularized facts giving rise to a strong inference that the defendant acted with the requisite state of mind. To make that determination, a court will necessarily have to consider whether the facts leave open non-culpable explanations for the defendant's conduct, even where those facts do not affirmatively buttress the conclusion that the defendant acted without scienter. Where, for example, a plaintiff alleges, with regard to scienter, only that a corporate executive sold a higher (but not dramatically higher) number of shares than usual during the relevant period, a court should consider the high probability that there are innocent explanations for the executive's increased trading activity—a consideration that forecloses the conclusion that the facts give rise to a strong inference that the executive acted with scienter.[8]

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[8] By contrast, a sharp and atypical spike in trading activity could, depending on the circumstances, provide a strong basis for inferring scienter, because innocent explanations would be less probable.

Many of the leading cases apply precisely that mode of analysis. See, *e.g.*, *Credit Suisse*, 431 F.3d at 51 (noting that a court is not required to "turn a blind eye to the universe of possible conclusions stemming from a given fact or set of facts" where a complaint "leaves * * * a myriad of other possibilities wide open"); *Pirraglia* v. *Novell, Inc.*, 339 F.3d 1182, 1187 (10th Cir. 2003) (contending that "[w]hether an inference is a strong one cannot be decided in a vacuum").

2. In some cases, a court may determine that *some* facts in the complaint support the conclusion that the defendant acted with scienter, whereas *other* facts actually support the conclusion that the defendant acted without scienter. As the court of appeals in this case seemingly recognized (Pet. App. 20a), however, Section 21D(b)(2) requires a court to consider whether *all* of the facts alleged in the complaint, taken together, give rise to a strong inference of the requisite state of mind. See *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 897 (9th Cir. 2002); *Abrams* v. *Baker Hughes Inc.*, 292 F.3d 424, 431 (5th Cir. 2002). Such an approach is consistent with the broader principle that the plaintiff is the master of his complaint, see, *e.g.*, *Caterpillar Inc.* v. *Williams*, 482 U.S. 386, 392 (1987)—and that a plaintiff may plead himself out of court by including allegations that undermine his claim. See, *e.g.*, *Gutierrez* v. *Peters*, 111 F.3d 1364, 1374 (7th Cir. 1997). When the facts alleged in the complaint give rise to a substantial possibility that the defendant acted without scienter, the necessary "strong inference" of scienter will be lacking, because there will be an insufficient likelihood that the conclusion that the defendant acted with scienter follows from the facts alleged in the complaint as a whole.

3. In other cases, a court may determine that the *same* facts *simultaneously* provide affirmative support both for the conclusion that the defendant acted with scienter and for the alternative conclusion that the defendant acted without scienter. The existence of a plausible competing inference, however, "quite clearly impedes the plaintiffs' progress toward building the requisite strong inference of scienter." *Gompper*, 298 F.3d at 897. And where the facts as alleged give rise to a substantial possibility that the defendant acted without scienter, the inference of scienter cannot be said to be "strong" in the relevant sense (*i.e.*, "powerful," "forceful," or "hard to confute"). In such a case, the presence of a substantial contrary inference would foreclose the conclusion that scienter was highly likely on the basis of the facts alleged. Plainly, therefore, if the alleged facts give rise to "two seemingly equally strong [competing] inferences," Pet. App. 20a (quoting *Pirraglia*, 339 F.3d at 1188), a court must conclude that the inference of scienter is not itself "strong." See, *e.g.*, *Gompper*, 298 F.3d at 897.

D. The Reform Act's Heightened Pleading Standard For The Mental-State Element Of Securities Fraud Is Consistent With The Seventh Amendment

Finally, requiring a plaintiff to allege facts that "giv[e] rise" to a "strong" inference of scienter does not raise any valid concerns under the Seventh Amendment of the Constitution.

1. In diluting Section 21D(b)(2)'s "strong inference" requirement, the court of appeals expressed concern that a more stringent standard would potentially violate the Seventh Amendment. See Pet. App. 20a. But the text of Section 21D(b)(2) quite clearly commands a

heightened pleading standard, and the canon of constitutional avoidance "has no application in the absence of statutory ambiguity." *United States* v. *Oakland Cannabis Buyers' Coop.*, 532 U.S. 483, 494 (2001).

2. Respondents did not claim that dismissal of *their* complaint under Section 21D(b)(2) would violate the Seventh Amendment. Even if they had, that claim would lack merit.

This Court has explained that the purpose of the Seventh Amendment was "to preserve the substance of the common-law right of trial by jury, as distinguished from mere matters of form or procedure" and "particularly to retain the common-law distinction between the province of the court and that of the jury, whereby * * * issues of law are to be resolved by the court and issues of fact are to be determined by the jury." *Baltimore & Carolina Line, Inc.* v. *Redman*, 295 U.S. 654, 657 (1935). This Court has never held that a pleading requirement violates the Seventh Amendment. To the contrary, the Court has upheld against Seventh Amendment challenge a requirement that the defendant in a contract action file an affidavit "stating * * *, in precise and distinct terms, the grounds of his defense, which must be such as would, if true, be sufficient to defeat the plaintiff's claim in whole or in part." *Fidelity & Deposit Co.* v. *United States*, 187 U.S. 315, 318 (1902); see *Ex parte Peterson*, 253 U.S. 300, 310 (1920) (Brandeis, J.) (concluding that "[i]t does not infringe the constitutional right to a trial by jury, to require, with a view to formulating the issues, an oath by each party to the facts relied upon"). The Court rejected the argument that "the rule deprived the [defendant] of the *right* to trial by jury." *Fidelity & Deposit Co.*, 187 U.S. at 320. Instead, the Court reasoned that the rule merely "prescribe[d] the means of

making an issue" and that, when "[t]he issue [was] made as prescribed, the right of trial by jury accrues." *Ibid.* Moreover, in approving the appointment of an auditor to streamline the issues for trial, the Court rejected a Seventh Amendment challenge by characterizing the auditor's role as being "the same as that of pleading." *Peterson*, 253 U.S. at 310. The Court explained that "[n]o one is entitled in a civil case to trial by jury unless and except so far as there are issues of fact to be determined." *Ibid.*

Like the requirement at issue in *Fidelity & Deposit Co.*, the heightened pleading requirement in Section 21D(b)(2) merely imposes a threshold legal hurdle that a plaintiff must surmount in order to state a claim (and thereby obtain discovery); it does not trench upon the jury's prerogative to resolve disputed issues of fact. Cf. *Neely* v. *Martin K. Eby Constr. Co.*, 386 U.S. 317, 321 (1967) (stating that it is "settled" that Rule 50(b), which governs judgment as a matter of law after trial, does not violate the Seventh Amendment); *Pease* v. *Rathbun-Jones Eng'g Co.*, 243 U.S. 273, 278 (1917) (concluding that "[t]he constitutional right of trial by jury presents no obstacle" to granting summary judgment).

It is true that, in an ordinary case, when a plaintiff presents sufficient evidence at trial that would support at least a reasonable inference in the plaintiff's favor as to each element of the claim, the plaintiff would be entitled to reach the jury on that claim, and the defendant would not be entitled to judgment on that claim as a matter of law. See 9A Wright & Miller § 2528, at 288-289 & nn.2-3 (2d ed. 1995) (citing cases).[9] The practical

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[9] There appears to be a circuit conflict on the question whether the Reform Act alters not just the pleading standard but the substantive

effect of Section 21D(b)(2) is to prevent a plaintiff who alleges facts that give rise only to a reasonable inference of scienter from proceeding to discovery, even if the plaintiff would ultimately be able to prove those facts at trial. But all heightened pleading standards have the effect of preventing a plaintiff from getting discovery on a claim that might have gone to the jury, had discovery occurred and yielded substantial evidence. Heightened pleading requirements have nevertheless not been thought to raise serious Seventh Amendment problems. The Reform Act's heightened pleading requirement for scienter likewise raises no such problems, because the jury retains the power to resolve any disputed factual issue once the plaintiff has satisfied the congressionally "prescribe[d] * * * means of making an issue." *Fidelity & Deposit Co.*, 187 U.S. at 320.

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proof standard for scienter as well. Compare *Geffon* v. *Micrion Corp.*, 249 F.3d 29, 36 (1st Cir. 2001) (stating that "we agree with the district court that the judicial reasoning applicable to imposing heightened pleading requirements is at least as forceful, if not more so, with regard to proof requirements that a trial judge must consider in deciding whether to allow a motion for summary judgment") (internal quotation marks and brackets omitted), with *Howard* v. *Everex Sys., Inc.*, 228 F.3d 1057, 1064 (9th Cir. 2000) (stating that, under the Reform Act, "the standard of summary judgment or [judgment as a matter of law] remains unaltered"). To the extent that the Reform Act altered the proof standard, it would eliminate any Seventh Amendment concerns, no matter what the standard at the pleading stage. For the reasons outlined in the text, however, Section 21D(b)(2)'s heightened pleading requirement does not implicate any such concerns, and the Court therefore need not address the question at this time.

CONCLUSION

The judgment of the court of appeals should be vacated, and the case remanded for further proceedings.

Respectfully submitted.

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No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF FOR AMALGAMATED BANK, AS TRUSTEE FOR THE LONGVIEW COLLECTIVE INVESTMENT FUND, CHANGE TO WIN, AND THE CtW INVESTMENT GROUP AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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IN THE

Supreme Court of the United States

No. 06-484

TELLABS, INCORPORATED AND RICHARD NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF FOR AMALGAMATED BANK, AS TRUSTEE FOR THE LONGVIEW COLLECTIVE INVESTMENT FUND, CHANGE TO WIN, AND THE CtW INVESTMENT GROUP AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

INTEREST OF *AMICI*[1]

Amalgamated Bank is America's oldest labor-owned bank. Its $7 billion LongView Collective Investment Fund invests assets in the American securities market, mostly for the benefit of pension fund beneficiaries. Change to Win is an

[1] This brief was not authored, in whole or in part, by counsel for either party, and no person or entity other than *amici*, their members and their counsel made a monetary contribution to the preparation or submission of this brief. The parties' general letters of consent to the filing of this and other *amicus* briefs have been filed with the clerk.

alliance of seven partner unions and six million workers, united to build a new movement of working people that can meet the challenges of the global economy and restore the American Dream: a paycheck that can support a family, affordable health care, a secure retirement, and dignity on the job.[2] The CtW Investment Group, which is affiliated with Change to Win, was established in February 2006 to protect the retirement security of Change to Win workers who participate in Taft-Hartley and public pension funds with approximately $1.5 trillion in assets. Because these funds are responsible for supporting the retirement benefits of their participants, they are diversified, are focused on long-term appreciation, and are particularly concerned with corporate governance issues, including the prevention of securities fraud, as a means of achieving reliable long-term results. In short, these *amici* are the paradigmatic "institutional investors" to whom Congress entrusted the presumptive leadership of private securities litigation.

Given the foregoing, the *amici* are concerned that appropriate litigation remains a strong factor to ensure corporate responsibility. They have a significant interest in assuring that the remedies granted fiduciary investors are not impaired by unreasonably high scienter pleading standards, or draconian and discriminatory dismissal procedures that will make it impossible for them to pursue meritorious claims.

SUMMARY OF ARGUMENT

As a threshold matter, *amici* here are in complete agreement with an overriding point treated fully elsewhere: That with Section 21D(b) of the Private Securities Litigation

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[2] The seven partner unions are: International Brotherhood of Teamsters, Laborers' International Union of North America, Service Employees International Union, UNITE HERE, United Brotherhood of Carpenters and Joiners of America, United Farm Workers of America, and United Food and Commercial Workers International Union.

Reform Act of 1995 ("Reform Act"),[3] Congress crafted a uniform pleading regime for §10(b) cases by adopting the Second Circuit's "strong inference of scienter" pleading test—the then-most-stringent standard. *Novak v. Kasaks*, 216 F.3d 300, 310 (2d Cir. 2000). That "strong inference" standard accepted well-pleaded facts as true and gave plaintiffs the benefit of reasonable inferences to determine if they "*may be able to prove* that defendants *more likely than not knew* that their . . . representations were false." *Cohen v. Koenig*, 25 F.3d 1168, 1174 (2d Cir. 1994).[4] That stringent standard never required, however, the consideration of "competing inferences" or defendants' "non-culpable explanations," or that the pleadings establish a "high likelihood" of scienter. Rather, courts still "accept as true the facts alleged in the complaint" (*Chill v. Gen. Elec. Co.*, 101 F.3d 263, 267 (2d Cir. 1996)), and "draw all inferences in favor of the pleader." *Cosmas v. Hassett*, 886 F.2d 8, 11 (2d Cir. 1989).[5] *Amici* here will not belabor the point beyond stating our agreement with it. *See* S. Ct. Rule 37.1.

This particular brief discusses, instead, (a) the myriad evidence contradicting Petitioners' arguments that securities fraud defendants deserve even *more* protection from private actions, (b) the lack of deference accorded the Securities and Exchange Commission's ("SEC") contradictory turnaround from its recent *amicus* position in numerous other post-Reform Act cases, and (c) the serious consequences at stake for America's investors.

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[3] Pub. L. No. 104-67, 109 Stat. 737 (1995).

[4] Emphasis added throughout and citations omitted, unless otherwise indicated.

[5] It is logical that Congress looked to the Second Circuit for guidance. *SEC v. Kasser*, 548 F.2d 109, 115 (3d Cir. 1977) (Second Circuit has special expertise in securities law); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 762 (1975) (Blackmun, J., dissenting) (Second Circuit is "the 'Mother Court' in [the securities] area").

Petitioners and their *amici* seek discriminatory pleading and radically liberalized dismissal rules that they claim are embedded in the "strong inference" pleading language of the Reform Act. In so doing, they demean the value of private enforcement of the securities laws—whether on a class or individual basis.[6] The present submission shows that the interpretations that Petitioners and their *amici* urge were never adopted by Congress, and empirically demonstrates the continuing importance of private securities suits, as well as the absence of data indicating that those suits are excessive or are being abused.

Among Petitioners' *amici*, the SEC's position is particularly disappointing—for the new position is patently inconsistent with that agency's mission to protect investors. The SEC contradicts its long-standing acknowledgement that private suits provide a valuable supplement to its limited enforcement resources, as well as the importance of those suits in policing the markets and compensating investors. Indeed, the SEC's new position contradicts its stance in at least ten prior *amicus* submissions concerning the Reform Act—namely that the Reform Act adopted the Second Circuit's "strong inference" of scienter pleading standard. *See* Appendix hereto at 1a-3a (compiling examples of SEC's recent *amicus* language concerning the "strong inference" standard). Such a newfound contradictory position—especially in *private* actions in which the SEC lacks practical experience—warrants no deference.

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[6] While Petitioners and their *amici* imply that these radically different dismissal standards would apply only to class actions, in fact the language they rely on applies to "*any private action.*" 15 U.S.C. §78u-4(a)(2)(A)(ii). In other words, at risk here is effective private enforcement *across the board.*

Seldom has an *amicus* position taken by the SEC attracted such widespread public criticism. A recent article in *The New York Times* crystallized the criticism:

> [T]he commission filed a little-noticed brief in the Supreme Court *urging the adoption of a legal standard that would make it harder for shareholders to prevail in fraud lawsuits* against publicly traded companies and their executives.
>
> * * *
>
> Critics said that the moves signaled a major retrenchment from the post-Enron changes . . . . "It is clear from these actions that this is a commission intent on reversing seven decades of rule making, by Democrats and Republicans, that have protected investors . . . ." said Lynn E. Turner, a former chief accountant at the commission . . . .
>
> * * *
>
> "After reading the brief, one has to wonder if the S.E.C. is now on the side of the defense bar," said Professor Fisch . . . . "*This does not read like an S.E.C. brief since it does not articulate anything about the commission's experience in the area. It reads, instead, like a litigant's brief.*"

Stephen Labaton, *S.E.C. Seeks to Curtail Investor Suits*, N.Y. Times, Feb. 13, 2007, at C1.[7]

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[7] *See also SEC Brief Favors Limiting Investor Suits*, Associated Press, Feb. 13, 2007 ("Barbara Roper, director of investor protection for Consumer Federation of America, called the agency's filing of the brief 'a very troubling sign that the SEC may be increasingly looking to intervene in these cases to restrict the rights of investors.'"); Jonathan Peterson, *Critics Fear SEC Chief Is Seeking To Limit Investors' Ability To Sue*, Los Angeles Times, Feb. 20, 2007, at C1 ("some observers feared the SEC was playing favorites, taking the side of corporate managers"); Gretchen Morgenson, *S.E.C. Facing Wide Review of Practices*, N.Y. Times, Oct. 27, 2006, at C1 (Chairman of the Senate Finance Committee "asked

At bottom, Congress designed the Reform Act's heightened pleading standard to create uniformity—and yet Congress's objective continues to be frustrated.[8] This situation would be *worsened* by the conflicting results that would flow from pleading-stage consideration of "innocent inferences" and "non-culpable explanations," *i.e.*, defendants' favorable spin and factual denials. Worse, interpreting "strong" to mean "high likelihood" would require plaintiffs to *plead* facts beyond the "more likely than not" preponderance-of-the-evidence *proof* standard (*see Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 (1983)), violating the right to a jury trial. If judges must weigh "non-culpable explanations" and "innocent inferences," assertions not subject to Rule 11 will enter the dismissal equation. Such assertions cannot be reliably weighed at the pleading stage and no objective standards exist to determine their veracity. Precedents will become confused and outcomes less predictable—a result that this Court rejects.[9]

[GAO] to conduct a review of the commission because he was growing concerned . . . about whether it is 'faithfully adhering to its mission'"); Edward Siedle, *The Irrelevant SEC—In Bed With the Industry It's Supposed to Regulate, It Needs a Shake-Up*, Forbes, Nov. 27, 2006 ("[T]he federal agency charged with safeguarding investors is on the verge of becoming irrelevant. If you want protection from investment pitfalls, you're going to get it from the private sector.").

[8] *See, e.g., Helwig v. Vencor, Inc.*, 251 F.3d 540, 549 (6th Cir. 2001) (en banc) ("the aftermath of the PSLRA has been anything but uniform as courts attempt to divine how much of the Second Circuit standard Congress intended to incorporate"), *cert. dismissed*, 536 U.S. 935 (2002); Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?* 2003 U. Ill. L. Rev. 913, 926 (2003) ("It is clear that Congress did not achieve one stated goal with respect to the pleading standard—ending the pre-PSLRA circuit split over the pleading requirements in securities fraud cases. Courts have split sharply over precisely what the "strong inference" portion of the standard requires.").

[9] *See Cent. Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 188-91 (1994) (rejecting aiding and abetting liability as "the rules for determining [it] *are unclear*, in 'an area that demands *certainty and*

This Court should achieve uniformity by ruling that the Reform Act adopted the Second Circuit's "strong inference" scienter pleading standard, and remand for a determination of whether the complaint in issue satisfies that standard.

ARGUMENT

I. PRIVATE ENFORCEMENT SUITS PLAY AN IMPORTANT ROLE IN POLICING OUR MARKETS AND COMPENSATING INVESTORS; THEY ARE NOT BEING ABUSED OR HARMING CORPORATIONS, BANKS, ACCOUNTING FIRMS OR OUR MARKETS

Although the SEC has primary authority for enforcing §10(b) of the 1934 Act, this Court, Congress, and the SEC have long supported private suits under §10(b). This Court has called such complementary suits "a most effective weapon in the enforcement" of securities laws (*J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)), a "necessary supplement to Commission action" (*id.*), and "an essential tool for enforcement of the 1934 Act's requirements." *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988).[10]

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predictability,'" and it would lead to "the undesirable result of decisions '*made on an ad hoc basis, offering little predictive value*'").

[10] *See also Blue Chip*, 421 U.S. at 729-30; *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985); *Randall v. Loftsgaarden*, 478 U.S. 647, 664 (1986). Petitioners and their *amici* seek a crabbed, anti-remedial interpretation of the 1934 Act, despite this Court's repeated admonition that §10(b) be interpreted *flexibly* to facilitate its remedial purposes. *See SEC v. Zandford*, 535 U.S. 813, 819 (2002) (unanimous opinion explaining "statute should be 'construed "not technically and restrictively, but flexibly to effectuate its remedial purposes"'") (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972)); *see also Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) (unanimous opinion stating that §10(b) "must be read flexibly, not technically and restrictively").

While the Congressional Conference Committee considering the Reform Act was clearly concerned with perceived abuses of §10(b) suits, that Committee's report nonetheless recognized that such suits were "an indispensable tool" for defrauded investors to recover without having to rely on government action, and noted that they "promote public and global confidence in our capital markets and help to deter wrongdoing."[11] The liberalized dismissal standard now urged upon the Court by Petitioners and their *amici* would undermine Congress's effort—reflected in its comprehensive review and revision of private securities suits—to emphasize vigorous private enforcement while barring meritless claims.

The SEC also has repeatedly praised private §10(b) suits as a supplement to Commission enforcement authority. As recently as 2003 the SEC noted that:

> Private litigation . . . offers the dual benefit of complementing Commission enforcement action and providing a mechanism to compensate investors through the award of restitution or damages. . . . The ability of investors to fully recover their losses, indeed, may largely depend on the use of private actions. Further, courts have recognized that the *Commission's limited resources may oblige it to prosecute only the most "flagrant abuses*," and that private actions complement Commission enforcement action and allow for the fullest investor recovery.[12]

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[11] H.R. Conf. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 730.

[12] SEC, Report Pursuant to Section 308(c) of the Sarbanes-Oxley Act of 2002, at 19-20 (Jan. 24, 2003), http://www.sec.gov/news/studies/sox308creport.pdf; *see also* 58 S.E.C. Docket 697-322 (Dec. 15, 1994) ("The Commission has consistently stressed the importance of and supported private rights of action under the antifraud provisions of the securities laws."); Testimony of Arthur Levitt, U.S. Securities and Exchange Commission, *Concerning Litigation Reform Proposals Before the Subcommittee on Telecommunication and Finance Committee on Com-*

Given the Commission's limited resources, it came as no surprise when a recent study found that the SEC detected *only 6%* of reported cases of corporate fraud at large companies between 1996 and 2004.[13]

Petitioners' proposal would enable dishonest actors to win dismissals on the pleadings by proffering speculative and unfounded claims that remain immune from the acid tests of sanctions, discovery, and the perjury laws. Such a result would conflict with this Court's precedents "[making] it clear that rules facilitating §10(b) litigation 'support the congressional policy embodied in the 1934 Act' of combating all forms of securities fraud." *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 376 (1991) (Kennedy, J., dissenting) (citing *Basic*, 485 U.S. at 245.) The entire investing public would be harmed.

Nor should the Court be swayed by arguments that "speculative" or "frivolous" §10(b) suits abound. Numerous Reform Act provisions already make it significantly more difficult to plead §10(b) cases. To wit: each alleged misstatement's falsity must be specifically pleaded, specific facts must be pleaded to raise a strong inference of each defendant's scienter, and all facts supporting plaintiff's information and belief must be pleaded. 15 U.S.C. §78u-4(b)(1)(B). As a result, many valid suits are dismissed every year; indeed, securities fraud cases at HealthSouth, Tyco, and WorldCom, filed in October 1998, December 1999, and November 2000 when those frauds were ongoing, were nonetheless dismissed

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merce (Feb. 10, 1995), http://www.sec.gov/news/testimony/testarchive/1995/spch025.txt ("Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws.").

[13] Alexander Dyck, Adair Morse & Luigi Zingales, *Who Blows The Whistle On Corporate Fraud?*, U.C. Berkeley Law and Economics Workshop, Apr. 10, 2007.

for failure to meet the heightened Reform Act pleading standard.[14] Later, these frauds burst open and the CEOs involved were ousted and indicted and new complaints were filed. But the fact that the early cases—which pleaded the frauds that were then occurring—were dismissed under the Reform Act's pleading standard is a cautionary tale as to the need for a pleading standard that does not ignore "*practicalities of litigation*" or "*tip[] the scale too far in favor of the wrongdoers*." *Lampf*, 501 U.S. at 374, 377, 379.

The Reform Act also imposed a *mandatory* discovery stay so long as *any* motion to dismiss is pending, 15 U.S.C. §78u-4(b)(3)(B), making it impossible for a securities fraud plaintiff to obtain discovery to create a case, and creating powerful disincentives for a plaintiff to file a flimsy complaint in an effort to inflict expense and extract a settlement. The Reform Act even requires a judicial sanctions review at the end of every dismissed case, and mandates the imposition of sanctions (presumed to be the entire cost of defense) for any frivolous allegation in a dismissed complaint. 15 U.S.C. §78u-4(c)(1). Protection against frivolous suits does not require a pleading bar so high that meritorious claims are blocked.

If anything, private enforcement should be enhanced at this point. The list of household corporate names caught up in post-Reform Act scandals is dizzying: Enron, WorldCom, Adelphia, Global Crossing, Tyco, Computer Associates, HealthSouth, Qwest, Freddie Mac, Dynegy, Fannie Mae, Royal Ahold, Nortel, Hollinger, Parmalat, Refco, AOL Time Warner, and Tenet are only the most prominent. Nor were public corporation executives the only wrongdoers. Wall Street analysts were corrupt often enough for Congress to

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[14] *In re Tyco Int'l, Ltd. Sec. Litig.*, 185 F. Supp. 2d 102, 109 (D.N.H. 2002); *Goldstein v. MCI Worldcom*, 340 F.3d 238, 243 (5th Cir. 2003). In *In re Healthsouth Corp. Sec. Litig.*, No. CV 98-J-2634-S, 2000 U.S. Dist. LEXIS 20650 (N.D. Ala. Sept. 13, 2000), a magistrate-judge recommended dismissal.

take action to erect *real* "Chinese Walls" between sell-side analysts and investment banking divisions of major financial firms. Banks were implicated in the Enron, WorldCom, and HealthSouth frauds. Mutual funds were beset with illegal practices such as "market timing," and many NYSE specialists cheated by "pennying," "front-running" and "interpositioning."

The shock waves from the post-Reform Act frauds continue to reverberate. In 2000, the SEC's former Chief Accountant publicly noted that over 75% of corporate CFOs had admitted to being asked by their CEOs to misstate earnings—*and that 40% had complied!*[15] Since 2001, at least 5,000 companies have restated their earnings—an admission, under Accounting Principles Board ("APB") Opinion No. 20, that those statements were false when published[16]—and major corporations, including Dell, General Motors, and Apple, *still* find themselves unable to issue current financial statements.

More recently, over 120 major public corporations have come under scrutiny for allegedly backdating stock options granted to executives and/or directors prior to Sarbanes-Oxley's passage in 2002.[17] That number may represent only the tip of the iceberg; a prominent study led by Harvard Law professor Lucian Bebchuk found that wholly 12% of sample

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[15] Speech by Lynn Turner, SEC Chief Accountant, *Executive Ethics Forum: Today's Ethics Yield Tomorrow's Behavior* (Sept. 29, 2000).

[16] David Reilly, *Restatements Still Bedevil Firms—Overall Total Hits a Record as Big Companies Improve*, Wall St. J., Feb. 12, 2007, at C7; *see generally* APB Opinion No. 20.

[17] *The Wall Street Journal* maintains an "Options Scorecard" at www.wsj.com. As of March 4, 2007, it listed over 120 companies that had disclosed either government probes, misdated options, restatements and/or executive departures.

firms had provided at least one stock-option grant whose timing was the result of manipulation from 1996-2005.[18]

As leveraged buyouts and management-led buyouts have returned to Wall Street, so has insider trading. The SEC just unveiled charges in what it called a "brazen" scheme whereby several blue-chip investment firms sent insider tips to major hedge funds,[19] and an independent study commissioned by *The New York Times* found that 41% of companies receiving buyout bids during a recent 12-month period "exhibited *abnormal and suspicious trading* in the days and weeks *before those deals became public.*"[20] Financial fraud and malfeasance remain powerful threats to investors.

In contrast, there is no evidence that private enforcement of our securities laws is hurting our nation's markets or its economy. In 2006, while both Wall Street profits[21] and merger-and-acquisition activity[22] hit record highs, new filings of securities class action suits *continued to decline*. According to a recent study by NERA Economic Consulting, cal-

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[18] Lucian Bebchuk, Yaniv Grinstein & Urs Peyer, *Lucky CEOs*, Harvard Law School and NBER (Nov. 16, 2006), http://www.issproxy.com/pdf/LuckyCEOs_Bebchuk-Grinstein-Peyer.pdf. Bebchuk, *et al.*'s sample included "all the at-the-money, unscheduled grants awarded to public companies' CEOs during the decade of 1996-2005." *Id.* at 2.

[19] Randall Smith, Kara Scannell & Paul Davies, *A 'Brazen' Insider Scheme Revealed*, Wall St. J., Mar. 2, 2007, at C1.

[20] Gretchen Morgenson, *Whispers of Mergers Set Off Bouts of Suspicious Trading*, N.Y. Times, Aug. 27, 2006, at 1.

[21] Ben White & David Wighton, *Wall Street Banks Report Record Earnings*, FT.com, Dec. 14, 2006.

[22] Peter Thal Larsen, *Takeovers Reach a Record High*, Financial Times, Jan. 25, 2007; Dennis K. Berman, *How to Assess 2007's M&A Activity*, Wall St. J. Online, Jan. 16, 2007, at C1; Dennis K. Berman, *Year-End Review of Markets & Finance 2006—Can M&A's 'Best of Times' Get Better?—Private Equity Fuels a Frenzy of Deals*, Wall St. J., Jan. 2, 2007, at R5.

endar year 2006 saw just 135 companies sued out of over 20,000 public companies, mutual funds and investment vehicles susceptible to §10(b) suits—"a 36% drop from 2005 levels, and a 44% decline from the post-PSLRA average."[23] NERA also found that "[d]ismissal *rates have nearly doubled* since [the passage of the] PSLRA," with more than 38% of class actions filed between 1999 and 2004 ending in dismissal.[24] As one prominent investor advocate noted in reaction to the SEC's *amicus* brief in this case, "'[w]ith the number of securities class actions falling, it's hard to see a compelling need to raise the bar.'"[25]

Nor do recent headline-grabbing, multi-billion-dollar settle ments suggest this Court's intervention is necessary to stop "meritless" §10(b) suits. A recent study by PricewaterhouseCoopers pointed to "the severity of some of the corporate accounting scandals and alleged financial frauds"

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[23] Todd Foster, Dr. Ronald I. Miller & Dr. Stephanie Plancich, *Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar*, NERA, Economic Consulting (Jan. 2, 2007), http://www.nera.com/Publication.asp?p_ID=3028 ("NERA 2006 Study"); *see Distribution of Publicly Traded Companies, by Listing Venue* (Apr. 23, 2006), http://www.sec.gov/ info/smallbus/acspc/appendj.pdf; *Number of Investment Companies*, Investment Company Fact Book (2006), http:\\www.icifactbook.org/data/06_fb_Sec1_chart.2xls.

[24] NERA 2006 Study; *see also Securities Class Action Case Filings – 2006: A Year in Review*, Cornerstone Research (2007), http://securities.Cornerstone.com/pdfs/ YIR2006.pdf ("Class action securities fraud filings, plunged to a record low in 2006 . . . 110 . . . the smallest number of filings in a calendar year since the adoption of the [95 Act]. Filings are down by 38 percent from the 178 filed in 2005 and are 43 percent lower than the ten-year historical average of 193.").

[25] Jonathan Peterson, *Critics Fear SEC Chief Is Seeking to Limit Investors' Ability to Sue*, Los Angeles Times, Feb. 20, 2007, at C1 (quoting Amy Borrus, deputy director of the Council of Institutional Investors).

as a driving force behind recent mega-settlements.[26] NERA Economic Consulting agreed, concluding that:

> Changes in investor losses over time are sufficient to explain both the headline settlements of recent years and the trends in median settlements. That is, while average settlements have been rising, *there is no statistical evidence* that this is the result of a more difficult litigation environment for defendants.[27]

Reports of the death of this nation's global financial leadership have been greatly exaggerated. Researchers at Goldman Sachs recently criticized two studies purporting to show that "legal and regulatory practices" such as "the risk and unpredictability of litigation" in the United States would drive business away from Wall Street. In a February 2007 issue of *Global Economics Weekly*, the researchers retorted that "we do not see [such factors] as the critical drivers behind the shift in financial market intermediation, even in the aggregate. Quite simply, economic and geographic factors matter more."[28] Nor, as has been asserted, is the United States losing out in the IPO market, for according to a recent study "evidence [] clearly illustrates . . . the US market remains an

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[26] *2004 Security Litigation Study*, PricewaterhouseCoopers LLP (2005), http://www.pwc.com/extweb/pwc.publications.nsf/ docid/8bdF8eF42b852570180074F891 ("PWC 2004 Study") at 8.

[27] NERA 2006 Study at 8; *see also* Laura E. Simmons & Ellen M. Ryan, *Post-Reform Act Securities Settlements—2005 Review and Analysis*, Cornerstone Research (2006), http://securities.cornerstone.com/pdfs/settlements_2005.pdf at 2 ("In spite of the increase [in average settlement size] in 2005, it is noteworthy that the median settlement amount still remains less than $10 million."); *id.* at 4 ("The discrepancy between the magnitude of the median and average statistics arises from a small number of cases for which 'estimated damages' are quite large. There were twelve settlements in 2005 with 'estimated damages' over $5 billion.").

[28] Goldman Sachs Economic Research, *Is Wall Street Doomed?*, Global Economics Weekly, Feb. 14, 2007, at 2.

inviting locale for IPOs by both domestic and foreign issuers."[29]

Finally, to enact Petitioners' revised pleading standard would curtail or eliminate the public good—in the form of low-cost disincentives to fraud—that large institutional investors deliver when they aggressively litigate fraud claims. The Reform Act sought to enable large institutions to gain lead plaintiff status more easily, and it worked: "The rate of cases filed by public or institutional funds has grown significantly since 1996."[30] The theory underlying this policy change—that large institutional holders can more effectively prevent securities litigation abuses—has also panned out: law professor Michael A. Perino has found that cases led by public pension funds "have greater attorney effort[] and have lower fee requests and awards than cases with other types of lead plaintiffs," suggesting "that public pensions do in fact act as effective monitors of class counsel."[31]

These lead plaintiffs—"a more knowing and demanding kind of plaintiff"[32]—are sophisticated, have huge investment portfolios, and suffer large losses when defrauded. As experienced fiduciaries, they have distinguished boards that are advised by independent counsel. Contrary to Petitioners' and

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[29] *Making It in the USA: Foreign IPO Issuers Continue to Flock to US-Based Exchanges*, Lab Thomson (Jan. 30, 2007) (on file with counsel).

[30] PWC 2004 Study at 15; *see also* 141 Cong. Rec. H 13691, at *13699 (expressing Congress's clear intent that institutional investors take a more active role in securities class action suits, "to return the securities litigation system to [its prior] high standard").

[31] Michael A. Perino, *Institutional Activism through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions*, St. John's University Legal Studies Research Paper No. 06-0055, at 1 (Oct. 2006), http://ssrn.com/abstract=938722.

[32] *Classier Actions*, The Economist, Feb. 17, 2007 ("Securities Lawsuits . . . [s]hareholder class actions are fewer in number, but bigger and better led[.]").

their *amicis*' carping, these lead plaintiffs are not "professional plaintiffs,"[33] nor do they file "frivolous" suits. Rather, when institutional investors lead cases, they return substantial value to shareholders,[34] creating a powerful incentive for corporate executives to avoid lawbreaking, and enhancing honesty and accountability across the board. The successful pursuit of well-established remedies by the very institutional investors Congress sought to empower via the Reform Act does not justify a judicially liberalized dismissal standard enabling fraudulent behavior by corporations and financial interests.

In denying some of the motions to dismiss in *Enron*, Judge Melinda Harmon put the issue before the Court in perspective. Echoing Fifth Circuit Judge Robert Parker, Judge Harmon described the Reform Act as "'a mechanism for winnowing out suits that lack a requisite level of specificity,'" but added that the Act "'was not meant to let business and management run amuck to the detriment of shareholders.'" *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235

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[33] In fact, the Reform Act included a provision that *eliminated* "professional" plaintiffs by limiting the number of class action suits an investor could lead in any five-year period. 15 U.S.C. §78u-4(a)(3)(B)(vi); *see also* H.R. Conf. Rep. No. 104-369, at 35 ("Institutional investors . . . do not represent the type of professional plaintiff [the Reform Act] seeks to restrict.").

[34] PWC 2004 Study at 7 (citing "the role of public retirement fund and pension fund fiduciaries and institutional entities as 'lead plaintiffs' in class actions" as among the factors causing increased settlements); *see 2005 Securities Litigation Study*, PWC Advisory (2005), http://www.pwc.com/extweb/service.nsf/docid/6F1068F6F245D6D1802572260047212/$file/study_%20seclit.pdf, at 17 ("Such huge settlements can be associated with several factors: . . . the role of lead plaintiffs (many of which are now . . . institutions such as pension funds . . . .")); *see also* NERA 2006 Study at 9 ("Cases with an institutional investor acting as lead plaintiff settle for approximately one-third more on average. It is impossible to judge whether this correlation reflects the actions of the lead plaintiff, or the nature of the cases in which institutions choose to be lead plaintiffs.").

F. Supp. 2d 549, 593 (S.D. Tex. 2002). Rather, Judge Harmon warned:

> The PSLRA's significance as a protective shield for business must be viewed within the context of the private right of action, granted decades before, to defrauded investors injured by corporate management, auditors, outside counsel, and investment bankers where their conduct allegedly violated the federal securities laws. . . . *The importance of this tool has been highlighted by recent disclosures of extraordinary corporate misconduct.*

Id. at 593-94.

In *Enron*, injured shareholders have thus far achieved a $7.3 billion recovery, the largest in history. Most of that recovery has come from major banks implicated in the *Enron* fraud. Despite the unimpeachable evidence of corporate fraud at Enron, however, it is not clear that the *Enron* lead plaintiff could have either pleaded a "high likelihood" of scienter by the bank defendants, or survived those defendants' "non-culpable explanations" and "innocent inferences." If not, the victims of that unprecedented fraud would have recovered little.

Such a system, sought now by Petitioners, would create disincentives for honest behavior by corporate executives and their accountants, lawyers, and bankers, and would undermine investor confidence as well as our citizens' faith in our legal system.

II. THE SEC IS NOT ENTITLED TO DEFERENCE IN THIS CASE BECAUSE IT IS ADDRESSING A MATTER OUTSIDE ITS PRIMARY JURISDICTION AND HAS CHANGED ITS POSITION

The views of an administrative agency are entitled to deference only where they reflect a "consistent, longstanding interpretation" of its statute. *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 556 n.20 (1979). Here, the SEC opines on an issue not within its particular expertise and with a view that directly contradicts the position it otherwise has uniformly taken since the passage of the Reform Act. Moreover, it has done so without either acknowledging its prior position or explaining the rationale for its about-face. Consequently, its "new" position warrants no deference.[35]

The issue presented in this case is not within the SEC's primary jurisdiction or expertise. Rather, it involves a matter of pleading and practice controlled by the Federal Rules of Civil Procedure and a provision of the Reform Act addressed to *private* securities litigation.[36] On this matter, then, the SEC has no special standing and its views are not entitled to

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[35] *See AFSCME v. Am. Int'l Group, Inc.*, 462 F.3d 121, 126-30 (2d Cir. 2006) (rejecting the SEC's interpretation of one of its own regulations because it was inconsistent with the position the SEC had taken for 16 years, noting: "In its amicus submission, the SEC fails to so much as acknowledge a changed position, let alone offer a reasoned analysis of the change."); *In re Enter. Mortgage Acceptance Co., LLC Sec. Litig.*, 391 F.3d 401, 410 (2d Cir. 2004) (deference to SEC's views on Sarbanes-Oxley "would [] be inappropriate because the SEC's area of expertise does not afford it particular insight"); *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 42 n.27 (1977) ("Even if the agency spoke with a consistent voice, however, its presumed 'expertise' in the securities-law field is of limited value when the narrow legal issue is one peculiarly reserved for judicial resolution . . . .").

[36] The Reform Act's heightened pleading requirements affect only "private actions" and not those brought by the SEC. *SEC v. Prater*, 296 F. Supp. 2d 210, 215-16 (D. Conn. 2003).

more weight than any other litigant. *E.g.*, *Enter. Mortgage*, 391 F.3d at 410.

The Court has in fact rejected the SEC's views in several private action cases:

- *Lampf*, 501 U.S. at 352-61 (rejecting the SEC's position that a five-year statute of limitations should be applied to §10(b) actions);
- *Cent. Bank*, 511 U.S. at 176-78 (rejecting the SEC's position that §10(b) created aiding and abetting liability);
- *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 94 (1987) (rejecting the SEC's position that the Williams Act preempted an Indiana state law); and
- *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199, 214 n.33 (1976) (rejecting the SEC's attempt to "add a gloss to the operative language of the statute" and refusing to "examine the additional considerations of 'policy' [the SEC argued] may have influenced the lawmakers in their formulation of the statute").

Moreover, the position taken by the SEC here is inconsistent with a position it has uniformly and repeatedly presented to Congress and the courts in the past. *AFSCME*, 462 F.3d at 129 ("In its amicus submission, the SEC fails to so much as acknowledge a changed position, let alone offer a reasoned analysis of the change."). In testimony presented to the House in 1995, for example, the SEC *opposed* efforts to require plaintiffs to "establish" scienter and, in particular, to impose a test "more stringent than the Second Circuit test." 104 H. Rpt. 050 at "H.R. 10's Harsh Pleading Requirements are Unattainable."

> There is a significant difference between having to allege facts that give rise to a "strong inference" that the defendant acted knowingly or recklessly, and having to plead facts that "establish" that the defendant had the

> requisite state of mind. *We believe that it is inappropriate to establish any test more stringent than the Second Circuit test*, which many experts already believe is already too severe.
>
> Because we believe that the bill as reported may result in meritorious fraud cases being dismissed, we are unable to support this provision.

Id.[37] The SEC's opposition was heeded by legislators. *See* S. Rep. No. 104-98, at 15 (1995), *reprinted in* U.S.C.C.A.N. 679, 694 ("the Committee chose a uniform standard modeled upon the pleading standard of the Second Circuit"); 141 Cong. Rec. S 17,969 (1995) (Domenici) ("the conference report adopts the pleading standard utilized by the second circuit court of appeals"); *id.* at S 17,959 (Dodd), S17,934 (D'Amato), S 17,993 (Grams).

The Appendix collects excerpts from the numerous *amicus* briefs in which the SEC has repeatedly taken the position that the Reform Act adopted the Second Circuit test. In none of those statements does the SEC suggest that the test requires plaintiffs to plead facts that establish a "high likelihood" of scienter, or requires a court to weigh "non-culpable explanations" or "innocent inferences" against inferences drawn from the complaint. *See* Appendix at 1a-3a. The statements in the SEC's *Green Tree amicus* brief, excerpted at Appendix 4a-11a, are typical:

> The Reform Act uses the term "strong inference," which was developed as a scienter pleading standard in Second Circuit decisions . . . . It may be presumed, absent contrary evidence, that Congress intended to adopt the judicial definition of that well-established pleading standard. . . .

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[37] Although the House adopted HR 1058 which included the "establish scienter" requirement, H.R.1058—Securities Litigation Reform Act, 141 Cong. Rec. H2760, at *2769, that formulation was absent from the final bill.

> That standard is satisfied by strong circumstantial evidence of conscious misbehavior or recklessness . . . . A strong inference of scienter can also be shown by alleging motive and opportunity to commit fraud. These Second Circuit tests are proven, sound, widely used, and consistent with the Reform Act's purposes. Nothing in the Act shows that the Act deviates from these established means of pleading a "strong inference."
>
> * * *
>
> Congress calibrated the Act's pleading standards to balance multiple concerns. Congress sought to weed out meritless claims at an early stage, but it also wanted meritorious claims to proceed. . . .
>
> The Second Circuit's tests strike the right balance and provide a basis for uniformity. . . . At the same time, the Second Circuit tests are exacting. . . . [T]he Second Circuit's tests for showing a "strong inference" of scienter are proven, sound, widely used, and consistent with the Act's language and purposes.[38]

The SEC also has explained that the Securities Litigation Uniform Standards Act of 1998 ("Standards Act") reaffirmed Congress's adoption of the Second Circuit standard:

> In deciding whether to enact the Standards Act, it was crucial that Congress understand what the key provisions of the Reform Act meant, because the preemption of state law would make those provisions applicable to all of the covered class action suits. . . . The [Conference Committee] Statement also made clear that (*id.*):
>
> > the Reform Act establish[ed] a heightened uniform Federal standard on pleading requirements based upon

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[38] *See* Brief of the Securities and Exchange Commission as *Amicus Curiae* in Support of Appellant on the Issues Specified, *Fla. St. Bd. of Admin. v. Green Tree Fin. Corp.*, No. 99-3563 (8th Cir. Dec. 21, 1999) (excerpts at Appendix 4a-13a).

> the pleading standard applied by the Second Circuit Court of Appeals. . . .
>
> [1998 Conf. Rep. at 15.] The President shared the Conference Committee's view. His staff, along with the Commission, participated in shaping the legislation, and the assurances in the legislative history that the Reform Act did not alter the existing law on scienter were essential to the President's support of the bill in Congress. *See* 144 Cong. Rec. H10, 784-85, S12,445, S12,449-50 (1998). When the President signed the Standards Act, he emphasized that he agreed with the Commission's views on . . . the Second Circuit pleading standard, and that he was signing the Standards Act based on that understanding. *See* Statement of the President on Uniform Standards Act (Nov. 3, 1998).

Green Tree amicus, Appendix 12a-13a; *see Seatrain Shipbuilding Corp. v. Shell Oil Co.*, 444 U.S. 572, 596 (1980) ("views of subsequent Congresses . . . are entitled to significant weight").

Now, for the first time, and without acknowledging its previous statements, the SEC says that the "strong inference" standard requires courts to go *beyond* the complaint and plaintiff's allegations and weigh "the relative strength" of the inferences drawn from the complaint against those asserted by defendant. SEC Amicus Brief at 9, 25-26.[39]

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[39] The SEC urges imposing on private litigants a rule it would not have to comply with. In contrast to actions brought by private plaintiffs, the SEC asserts that the following test should be applied when it sues under §10(b) on its own authority:

> The reviewing court accepts as true the well-pleaded factual allegations of the complaint, draws all reasonable inferences in the plaintiff's favor, and determines whether the complaint, so read, sets forth facts sufficient to justify judgment for the plaintiff on any applicable legal theory.

This about-face is not entitled to deference. As Justice Powell noted in *Int'l Bhd. of Teamsters*, 439 U.S. at 566-67, "the SEC's position [is not] longstanding," and it has taken a "different position" than it had "repeatedly" taken in *amicus* briefs and Congressional testimony. Thus, where "the SEC's present position [was] flatly contradicted by its past actions," its new desires should yield to the "clear meaning of a statute, as revealed by its language, purpose, and history." *Id.* at 566; *see also United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 858 n.25 (1975) ("The SEC's position flatly contradicts what appears to be a rather careful statement of the Commission's views .... In view of this unexplained contradiction in the Commission's position we accord no special weight to its views.").[40]

SEC v. Rocklage, No. 06-1571, *Brief of the Securities and Exchange Commission, Appellee*, at 10 (1st Cir. June 2006), http://www.sec.gov/litigation/appellatebriefs.shtml. The SEC argues its factual allegations created "reasonable inferences" that defendants had the requisite scienter. *Id.* at 11, 13. In *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006), the Court of Appeal applied the dismissal standard the SEC asserted and affirmed the district court's denial of defendants' motion to dismiss. *Id.* at 3.

[40] The SEC claims that the Reform Act was "intend[ed] to *strengthen* existing pleading requirements" and was "not intend[ed] to codify the Second Circuit's case law interpreting [its] pleading standard." SEC Amicus Brief at 18. The Reform Act clearly strengthen the existing pleading standards, not by changing the Second Circuit "strong inference" standard as the Government suggests, but by including various specific requirements in the statute itself. As the Conference Committee explained: "The reason or reasons why the statement is misleading must also be set forth in the compliant [sic] in detail. If an allegation is made on information and belief, the plaintiff must state with particularity all facts in the plaintiff's possession on which the belief is formed." H.R. Conf. Rep. No. 104-369, at 41.

III. CHANGING DISMISSAL RULES TO REQUIRE THE WEIGHING OF "INNOCENT INFERENCES" AND "NON-CULPABLE EXPLANATIONS" WILL CREATE UNCERTAINTY AND CONFLICTING RESULTS IN §10(b) LITIGATION

Rule 12(b)(6)'s procedural matrix—that well-pleaded allegations are accepted as true, and plaintiffs are given the benefit of reasonable inferences—is a tried-and-true one. Courts have decades of experience applying it. A new pleading procedure not only will unsettle matters with respect to §10(b) cases, but also will encourage similar modifications of Rule 12(b)(6) for other cases with elevated pleading or proof standards.

Moreover, new dismissal procedures for securities cases, if deemed retroactive, will cause reexamination of scores of previously denied motions to dismiss in pending actions. Because these cases are now in discovery, reopening those motions will create a conflict: Plaintiffs will understandably attempt to utilize existing discovery in amendments to meet any newly heightened standards—and defendants will oppose them. Resolving such revisited motions could consume judicial resources for years.

At bottom, because the Reform Act's heightened pleading standard was intended to create pleading uniformity, it makes little sense now to introduce notions of "innocent inferences" and "non-culpable explanations"—factual denials and favorable spins—which will necessarily depend upon defendants' subjective states of mind and their evaluation at the pleading stage.[41] If judges are required to weigh "non-culpable

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[41] For instance, defendants will argue that it is irrational for a CEO to lie because if the fraud unravels, private, SEC, or DOJ suits—even CEO ouster—will follow, all carrying economic risk and reputational harm. This creates, they will argue, a compelling incentive to comply with the

explanations" and "innocent inference" arguments, factual assertions not subject to Rule 11 will be introduced into the dismissal equation. But those subjective assertions cannot be properly weighed at the pleading stage; there exists no objective standard to determine their veracity or weight. Precedents will become more confused and outcomes less predictable—an outcome that this Court abhors. *See Central Bank v. First Interstate Bank*, 511 U.S. 164, 188-191 (1994) (rejecting aiding and abetting liability in §10(b) cases as "the rules for determining aiding and abetting liability *are unclear* in 'an area that demands *certainty and predictability*,'" and it would lead to "the undesirable result of decisions '*made on an ad hoc basis, offering little predictive value*'" and "*would work a significant shift in settled interpretive principles*").[42]

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law which outweighs any inferences of motive or opportunity to commit fraud. CEOs will further argue that they were only overly optimistic in making the challenged statements, and that it is important for executives to be optimistic about solving the problems they encounter, and that because they were successful in overcoming prior challenges, they expected to overcome the problems at hand. They will argue suspicious-appearing stock sales were made only because of pending expiration of options, personal financial reversals, financial emergencies, or a desire to diversify holdings in anticipation of retirement—not trading on inside information. They will argue that they were unaware of problems, as they were too busy to look into the goings-on in the bowels of the company and relied on representations of regularity—false it turns out—of underlings. They will claim any misaccounting was beyond their expertise and in the domain of others, with the company's "numbers" having been approved by accountants, not them. None of these and many other potential assertions can be reliably weighed at the pleading stage. All involve factual issues that must be tested through the established process under appropriate judicial oversight.

[42] In short, what the corporate community seeks is a new set of barriers and discriminatory dismissal rules beyond what Congress enacted in 1995. This issue is properly for Congress not the Court.

CONCLUSION

The Court should achieve the uniformity Congress intended by ruling that the Reform Act adopted the Second Circuit's "strong inference" scienter pleading standard, and that this standard does not require considering "competing" or "innocent inferences" or "non-culpable explanations" or establishing a "high likelihood" of scienter. The case should be remanded for a determination whether the complaint satisfies (or can satisfy) that standard.

Respectfully submitted,

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APPENDIX

APPENDIX

Securities and Exchange Commission's Formerly Consistent Position on the Reform Act's Heightened Pleading Standards

"Congress ***explicitly adopted the Second Circuit's formulation for pleading scienter when it enacted the Reform Act***. Courts construing the Reform Act should apply that standard by using the proven tests that the Second Circuit has developed in the course of deciding many cases."

> *Zeid v. Kimberley*, Brief of the Securities and Exchange Commission, Amicus Curiae, No. 97-16070, 1997 WL 33555504 (9th Cir. Oct. 30, 1997);
>
> *See also In re Silicon Graphics Sec. Litig.*, Brief of the Securities and Exchange Commission, Amicus Curiae, No. 97-16240, 1997 WL 33551249, at *16 (9th Cir. Nov. 1997) ("Congress intended that courts would rely on the the Second Circuit tests in interpreting the pleading standard of the Reform Act.");
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> *See also In re Comshare, Inc. Sec. Litig.* Brief of the Securities and Exchange Commission, Amicus Curiae, No. 97-2098, 1997 WL 34039763, at *14 (6th Cir. Nov. 1997) ("The language and legislative history of the Reform Act leave no doubt that Congress adopted the Second Circuit's 'strong inference' formulation for pleading the Reform Act's 'required state of mind.'").

"It may be presumed from the Reform Act's 'strong inference' language, absent contrary evidence, that Congress intended to adopt the judicial definition of the well-established Second Circuit pleading standard, including its 'motive and opportunity' and 'strong circumstantial evidence' analytical tests."

Nathenson v. Zonagen, Brief of the Securities and Exchange Commission, Amicus Curiae, No. 99-20449, 1999 WL 33613893, at *12 (5th Cir. Sept. 30, 1999);

See also Bryant v. Avado Brands, Inc., Brief of the Securities and Exchange Commission, Amicus Curiae, No. 98-9253, 1999 WL 33631523, at *10 (11th Cir. Feb. 16, 1999).

"It may be presumed from the [95] Act's 'strong inference' language, absent contrary evidence, that Congress intended to adopt the judicial definition of the well-established Second Circuit pleading standard, including its [two] analytical tests."

* * * *

"***The Second Circuit's tests strike the right balance and provide a basis for uniformity.*** As explained in *Press*, 166 F. 3d at 538, the Second Circuit 'has resisted accepting general allegations of scienter' while declining 'to create a nearly impossible pleading standard when the "intent" of a corporation is at issue.'"

Fla. St. Bd. of Admin. v. Green Tree Fin. Corp., Brief of the Securities and Exchange Commission as Amicus Curiae in Support of Appellants on the Issues Specified, No. 99-3536 (8th Cir. Dec. 21, 1999) at pp. 8a-10a (excerpts attached hereto);

See also Weld v. Stage Stores, Inc., Brief of the Securities and Exchange Commission, Amicus Curiae, No. 00-20230, 2000 WL 34032458, at *5-*6 (5th Cir. June 23, 2000) ("These Second Circuit tests are proven, sound, widely used, and consistent with the Reform Act's purposes. Nothing in the Act deviates from these established means of pleading a 'strong inference.'");

See also In re K-Tel Int'l Inc. Sec. Litig., Brief of the Securities and Exchange Commission, Amicus Curiae, No. 003210, 2000 WL 35483737, at *1 (8th Cir. Nov. 15, 2000) ("The 'strong inference' pleading standard was developed in a long line of cases by the Second Circuit.");

See also Caprin v. Simon Trans. Serv., Brief of the Securities and Exchange Commission, Amicus Curiae, No. 01-4049, 2001 WL 34664973, at *1 (10th Cir. July 2, 2001).

"It is the Commission's view that the Reform Act's scienter pleading provision . . . adopts the Second Circuit standard for pleading scienter in a private action . . . . ***The Commission has expressed this view in amicus curiae briefs filed over the past 18 months in five other pending appeals raising the issue of the Reform Act's scienter pleading standard.***" [citing above amicus]

* * * *

"***The Commission believes . . . that it would be useful for the Court to have available to it the Commission's views on the important issue of the interpretation of the Reform Act's scienter pleading provision***. . . . We are, accordingly, submitting . . . a copy of the Commission's brief in *Bryant v. Apple South, Inc* . . . ."

Greebel v. FTP Software, Inc., Brief of the Securities and Exchange Commission, Amicus Curiae, No. 98-2194, 1999 WL 33911562, at *2-*5 (1st Cir. May 27, 1999).

* * * *

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 99-3536

FLORIDA STATE BOARD OF ADMINISTRATION,
Plaintiff/Appellant.

v.

GREEN TREE FINANCIAL CORPORATION; LAWRENCE M. COSS; ROBERT D. POTTS; EDWARD L. FINN,
Defendants/Appellees.

On Appeal from the United States
District Court for the District of Minnesota

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT ON THE ISSUES SPECIFIED

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* * * *

the courts to adopt those tests, under which "motive and opportunity" and "strong circumstantial evidence" are sufficient to plead scienter.

STATEMENT OF ISSUES

1. Whether the Reform Act's state of mind pleading provision alters the well-established law of this and every other circuit to have considered the issue that recklessness is sufficient to satisfy the state of mind requirement under Section 10(b) and Rule 10b-5.

2. Whether the Reform Act heightens the rigorous standard for pleading a "strong inference" of scienter that was developed in a long line of Second Circuit decisions and followed by many district courts in this Circuit in pre-Act cases, under which a private plaintiff may allege either (a) facts to show that the defendant had both a motive and an opportunity to commit fraud or (b) facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.

SUMMARY OF ARGUMENT

The Reform Act requires that private plaintiffs "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," but does not define that state of mind. The "required state of mind" language thus leaves untouched the well-established body of law in this and other courts that recklessness suffices to establish scienter under Section 10(b) and Rule 10b-5. Where the Reform Act modifies or eliminates the existing recklessness standard, it does so expressly. To date, at least five courts of appeals have concluded that the Reform Act's scienter pleading standard does not affect recklessness as a basis for liability.

The Reform Act uses the term "strong inference," which was developed as a scienter pleading standard in Second

Circuit decisions that many district courts in this Circuit have followed. It may be presumed, absent contrary evidence, that Congress intended to adopt the judicial definition of that well-established pleading standard. To date, at least two courts of appeals and the majority of district courts have so concluded.

That standard is satisfied by strong circumstantial evidence of conscious misbehavior or recklessness, and thus is consistent with pleading and proving recklessness. A strong inference of scienter can also be shown by alleging motive and opportunity to commit fraud. These Second Circuit tests are proven, sound, widely used, and consistent with the Reform Act's purposes. Nothing in the Act shows that the Act deviates from these established means of pleading a "strong inference."

Moreover, authoritative legislative history of the Reform Act and of the related, recently enacted Securities Litigation Uniform Standards Act of 1998 ("Standards Act"), Pub. L. No. 105-353, 112 Stat. 3227, confirms that in using the "strong inference" language Congress adopted the Second Circuit pleading standard. In fact, when the President vetoed the 1995 bill over concerns that that standard had not been adopted, the bill's managers, in the debate leading to an override of the veto, made clear their endorsement of that standard.

ARGUMENT

I. THE REFORM ACT'S STATE OF MIND PLEADING PROVISION DOES NOT DISPLACE THE LONG-STANDING JUDICIAL RULE THAT RECKLESSNESS SUFFICES TO SHOW SCIENTER UNDER SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 THEREUNDER.

The Reform Act's state of mind pleading provision does not change the well-settled law in this and all other circuits that have considered the issue that the required state of mind

under Section 10(b) and Rule 10b-5 encompasses recklessness. At least five courts of appeals have reached this conclusion. *See Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198-201 (1st Cir. 1999); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1281-84 (11th Cir. 1999); *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 548-51 (6th Cir. 1999); *Advanta*, 180 F.3d at 534-35; *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 537-38 (2d Cir. 1999);

* * * *

The Commission agrees. It also believes that elimination of recklessness liability would encourage corporate directors and officers to put their heads in the sand and would have enormously counterproductive effects on the integrity of corporate disclosure and the quality of corporate governance.

II. THE REFORM ACT ADOPTS, OR AT LEAST LEAVES IT TO THE COURTS TO ADOPT, THE SECOND CIRCUIT'S TESTS, UNDER WHICH "MOTIVE AND OPPORTUNITY" AND "STRONG CIRCUMSTANTIAL EVIDENCE" ARE SUFFICIENT TO PLEAD SCIENTER.

The Reform Act adopts the "strong inference" standard for pleading state of mind in private securities actions. 15 U.S.C. 78u-4(b)(2). The Second Circuit created the "strong inference" standard, and, in a long line of decisions, developed analytical tests for applying it. *See, e.g., Shields*, 25 F.3d at 1128 (citing cases); *Goldman v. Belden*, 754 F.2d 1059, 1070 (2d Cir. 1985). In the Second Circuit, a plaintiff could either "(a) allege facts to show that 'defendants had both motive and opportunity to commit fraud' or (b) allege facts that 'constitute strong circumstantial evidence of conscious misbehavior or recklessness.'" *E.g., Press*, 166 F.3d at 538. In pre-Reform Act cases, many district courts in this Circuit followed the Second Circuit's approach. *See* n.2, *supra*. There is no reason to reject that approach in cases under the Act.

As at least two courts of appeals and the majority of district courts have determined, the Reform Act's pleading standard does not reject recklessness or motive and opportunity as bases for pleading scienter. *See, e.g., Advanta*, 180 F.3d at 534-35 ("we hold that it remains sufficient [under the Act] for plaintiffs to plead scienter by alleging facts 'establishing a motive and an opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior'"); *Press*, 166 F.3d at 537-38; *In re Transcrypt Int'l Sec. Litig.*, No. 4:98CV3099, 1999 U.S. Dist. LEXIS 17540, at *23-24 (D. Nebr. Nov. 4, 1999); *Schlagel v. Learning Tree Int'l*, No. CV 98-6384 ABC(Ex), 1998 U.S. Dist. LEXIS 20306, at *41-48 (C.D. Cal. Dec. 29, 1998); *see also Comshare*, 183 F.3d at 551 (under Act, plaintiffs may plead recklessness, and "facts regarding motive and opportunity * * * may, on occasion, rise to the level of creating a strong inference of reckless or knowing conduct"); *Bryant*, 187 F.3d at 1283 ("we are in basic agreement with [*Comshare*]"); *Greebel*, 194 F.3d at 197 (permitting, in addition to pleading of recklessness, "use of motive and opportunity type pleading if it raises a strong inference"). Rather, the Reform Act adopts or leaves it to the courts to adopt the "motive and opportunity" and "strong circumstantial evidence" tests.

It may be presumed from the Act's "strong inference" language, absent contrary evidence, that Congress intended to adopt the judicial definition of the well-established Second Circuit pleading standard, including its "motive and opportunity" and "strong circumstantial evidence" analytical tests. *See Advanta*, 180 F.3d at 534 ("Congress's use of the Second Circuit's language compels the conclusion that the Reform Act establishes a pleading standard approximately equal in

stringency to that of the Second Circuit"); *Press*, 166 F.3d at 537.[7]

At a minimum, however, the Reform Act leaves it to the courts to decide whether to adopt those analytical tests, which many district courts in this Circuit did in pre-Act cases. As the body of precedent applying the Second Circuit standard shows, pleading strong circumstantial evidence of recklessness or pleading motive and opportunity is clearly consistent with pleading a "strong inference" of scienter, the language used in the Reform Act. Moreover, the Second Circuit's tests are consistent with the Act's purposes.

Congress calibrated the Act's pleading standards to balance multiple concerns. Congress sought to weed out meritless claims at an early stage, but it also wanted meritorious claims to proceed. *See* Joint Explanatory Statement of the Committee of Conference ("Statement of Managers"), Conference Report on Securities Litigation Reform, H.R. Conf. Rep. No. 104-369, at 31 (1995) ("1995 Conf. Rep."). Furthermore, Congress was concerned that "courts of appeals have interpreted Rule 9(b)'s requirement in conflicting ways, creating distinctly different pleading standards among the circuits," and sought to create a "uniform" national pleading standard, *id.* at 41, not "a new and untested pleading standard that would generate additional litigation," S. Rep. No. 104-98, at 15 (1995).

The Second Circuit's tests strike the right balance and provide a basis for uniformity. As explained in *Press*, 166 F.3d at 538, the Second Circuit "has resisted accepting gen-

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[7] *See generally Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554, 562 (1991) ("Because these decisions were part of the 'contemporary legal context' in which Congress enacted [the statute] * * * we may presume that Congress intended to codify these principles"); *Lorillard v. Pons*, 434 U.S. 575, 581 (1978). As discussed in Argument III, the presumption that Congress intended to adopt the Second Circuit standard is supported, not overcome, by the legislative history.

eral allegations of scienter" while declining "to create a nearly impossible pleading standard when the 'intent' of a corporation is at issue." The motive and opportunity test applies where fraud is most likely to have occurred, such as where the misrepresentation was allegedly made to induce an investment, or where inflation of revenues is accompanied by unusual, large-scale insider trading. *See Cohen v. Koenig*, 25 F.3d 1168, 1174 (2d Cir. 1994); *Rubinstein v. Collins*, 20 F.3d 160, 169-70 (5th Cir. 1994). It serves an important function by allowing the most credible claims of fraud to proceed.

At the same time, the Second Circuit tests are exacting. *See Advanta*, 180 F.3d at 534 ("the most restrictive prior to the Reform Act"); *Comshare*, 183 F.3d at 549 ("the most stringent test"); *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 979 (9th Cir. 1999) ("the most stringent existing standard"); *Stevelman v. Alias Research Inc.*, 174 F.3d 79, 84-86 (2d Cir. 1999) (stringently applying tests); *Phillips*, 190 F.3d at 621-24 (same). Conclusory allegations that defendants were attempting to inflate the stock price because they held shares in the company, to boost their compensation, or to retain their positions, do not suffice to plead motive. *See, e.g., Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995); *Shields*, 25 F.3d at 1130; *Melder v. Morris*, 27 F.3d 1097, 1102 (5th Cir. 1994). Nor do allegations that auditors were motivated to conduct a fraudulent audit to secure fees. *See, e.g., Melder*, 27 F.3d at 1103.

Rather, as a leading Second Circuit case held, the plaintiff must plead a motive consistent with "informed economic self-interest" and an opportunity to "achiev[e] concrete benefits by the means alleged." *Shields*, 25 F.3d at 1130. And where motive is not apparent, "the strength of the circumstantial allegations must be correspondingly greater." *Tuchman v. DSC Comm. Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994) (citing *Beck v. Manufacturers Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987)). Thus, the Second Circuit's tests for show-

ing a "strong inference" of scienter are proven, sound, widely used, and consistent with the Act's language and purposes.

Although the courts of appeals have been unanimous in holding that strong circumstantial evidence of recklessness (in at least some form, *see* pp. 6-7, *supra*) can give rise to a "strong inference" of scienter under the Reform Act, they appear to be divided on the role of allegations of motive and opportunity. The Commission believes that the reason is that courts have characterized the motive and opportunity test in different ways.

Courts that are not familiar with the test, and have seemed to limit use of motive and opportunity allegations under the Reform Act, have mistakenly suggested that the test can be satisfied by general averrals of "motive and opportunity." *See Silicon Graphics*, 183 F.3d at 979 (suggesting that test allows plaintiffs to "aver intent in general terms of mere 'motive and opportunity'"); *Greebel*, 194 F.3d at 197 ("merely pleading motive and opportunity, regardless of the strength of the inferences to be drawn of scienter"); *Bryant*, 187 F.3d at 1286 ("'bare allegations of motive and opportunity'"); *Comshare*, 183 F.3d at 551 ("bare pleading of motive and opportunity").

Courts that have applied the test in the past, and held that it satisfies the Reform Act, however, have indicated that this is incorrect. *See Press*, 166 F.3d at 538 (Second Circuit "has resisted accepting general allegations of scienter that would lead to the presumption of motive for any publicly-held corporation that 'desires its stock to be priced highly by the market'"); *Advanta*, 180 F.3d at 535 (adopting same pleading standard as *Press*); *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1423 n.12 (3d Cir. 1997) (stringently applying motive and opportunity test); *Shields*, 25 F.3d at 1130 (same). And the Reform Act makes clear that plaintiffs must state facts constituting a strong inference of the required state of mind "with particularity." *See Advanta*, 180 F.3d at 534.

In the Commission's view, allegations that satisfy a motive and opportunity test applied with the proper rigor and analytical precision give rise to a strong inference of scienter.[8]

* * * *

In deciding whether to enact the Standards Act, it was crucial that Congress understand what the key provisions of the Reform Act meant, because the preemption of state law would make those provisions applicable to all of the covered class action suits. Congress believed that it was particularly important to make clear that the Reform Act did not in any way change the existing law on scienter under Section 10(b) and Rule 10b-5 (*i.e.*, that recklessness is sufficient).

The Statement of Managers of the Standards Act explicitly and unambiguously states in this regard:

> It is the clear understanding of the managers that Congress did not, in adopting the Reform Act, intend to alter the standards of liability under the Exchange Act.
>
> The managers understand, however, that certain Federal district courts have interpreted the Reform Act as having altered the scienter requirement. In that regard, the managers again emphasize that the clear intent in 1995 and our continuing intent in this legislation is that neither the Reform Act nor [the Standards Act] in any way alters the scienter standard in Federal securities fraud suits.

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[8] The First Circuit offers no basis for its suggestion in *Greebel*, 194 F.3d at 196, that the Second Circuit tests would impede a court in "analyz[ing] the particular facts alleged in each individual case" or in developing and using "fact-specific inquir[ies]." Its statement, *id.* at 197 (quoting *Comshare*), that facts regarding motive and opportunity are proof of scienter, not "scienter itself," is beside the point; it is the Reform Act's "strong inference" language, not its "required state of mind" language, that refers to the Second Circuit scienter pleading standard.

1998 Conf. Rep. at 15. The Statement also made clear that (*id.*):

> the Reform Act establish[ed] a heightened uniform Federal standard on pleading requirements based upon the pleading standard applied by the Second Circuit Court of Appeals. Indeed, the express language of the Reform Act itself carefully provides that plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."

The President shared the Conference Committee's view. His staff, along with the Commission, participated in shaping the legislation, and the assurances in the legislative history that the Reform Act did not alter the existing law on scienter were essential to the President's support of the bill in Congress. *See* 144 Cong. Rec. H10,784-85, S12,445, S 12,449-50 (1998). When the President signed the Standards Act, he emphasized that he agreed with the Commission's views on both the scienter element and the Second Circuit pleading standard, and that he was signing the Standards Act based on that understanding. *See* Statement of the President on Uniform Standards Act (Nov. 3, 1998).

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IN THE

Supreme Court of the United States

TELLABS, INC. AND RICHARD C. NOTEBAERT, ,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.

Respondents.

On Writ Of Certiorari to the United States Courts of Appeals for the Seventh Circuit

AMICUS CURIAE BRIEF OF THE AMERICAN ASSOCIATION FOR JUSTICE IN SUPPORT OF RESPONDENTS

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IDENTITY AND INTEREST OF *AMICUS CURIAE*

The American Association for Justice ["AAJ"], formerly the Association of Trial Lawyers of America, respectfully submits this brief as *amicus curiae*. The parties have filed blanket letters of consent to the filing of amicus briefs with this Court.[1]

AAJ is a voluntary national bar association whose approximately 50,000 trial lawyer members primarily represent individual plaintiffs in personal injury cases and other civil actions, including securities fraud suits. Throughout its 40-year history, the association has championed the constitutional right to trial by jury as an essential part of democratic government, by which ordinary citizens hold accountable those who have wrongfully caused harm.

SUMMARY OF THE ARGUMENT

1. In 1995, Congress determined that the Federal Rules of Civil Procedure, specifically notice pleading provisions that have greatly eased the burden for litigants seeking legal redress on the merits of their grievances, did not adequately protect defendants in private securities fraud actions. The lawmakers found no cause for concern in jury verdicts imposing liability for fraudulent conduct. Indeed, Congress expressly noted the valuable role of such litigation in deterring and compensating the victims of illicit stock manipulation.

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[1] Pursuant to Rule 37.6, Amicus discloses that no counsel for a party authored any part of this brief, nor did any person or entity other than Amicus Curiae, its members, or its counsel make a monetary contribution to its preparation.

Congress was instead concerned with the filing of lawsuits that would not, and were not intended to, reach trial. "Strike suits," filed after a drop in a company's stock price with little or no indication of wrongdoing, subject defendants to "fishing expeditions" – broad, disruptive, and expensive discovery that exerts pressure on innocent defendants to settle baseless claims.

To rid the civil justice system of such abuses, Congress amended Section 10(b) of the Securities Exchange Act of 1934 to require that the complaint in a private suit under the Act "state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind." The statute does not, however, answer the question how "strong" an inference must be to survive a motion to dismiss under Rule 12(b)(6).

The court of appeals below answered that question in a fashion that strikes the balance Congress intended, allowing dismissal of baseless lawsuits while permitting meritorious cases to proceed to discovery and trial. A securities fraud complaint satisfies the "strong inference" standard "if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." That standard is familiar to federal courts, mirroring the standard for surviving a motion for summary judgment or directed verdict. More importantly, the standard is faithful to the constitutional command in the Seventh Amendment that the right of trial by jury shall be preserved.

2. Heightened pleading requirements, including those at issue here, clearly implicate Seventh Amendment concerns. Congress can, of course, define the proof requirements for liability under the

substantive law. Dismissal under fact pleading requirements that do no more than reflect the proof requirements necessary to establish liability does not deprive a plaintiff of the jury right.

Petitioner in this case, however, argues for a pleading standard that is higher than the standard of proof of scienter under the Securities Act. Authorizing judges to dismiss cases that otherwise would be entitled to reach the jury would clearly violate the Seventh Amendment, whose core purpose is to maintain the proper roles of the judge and the jury on disputed questions of fact.

The history of the Seventh Amendment and the Founders' passionate commitment to the jury has led courts to be vigilant in guarding this fundamental constitutional guarantee. The court of appeals properly construed the heightened pleading standard to avoid infringement of the jury right.

3. Petitioner asks this Court not only to impose a higher standard of "strong inference" than the court of appeals articulated, but also to engraft upon that standard three "principles" for judges ruling on motions to dismiss. None of these principles finds any support in the statutory text, and all would infringe upon the right to a jury trial.

Petitioner's first principle would require the judge to consider not only facts and inferences favorable to plaintiff, but also "contrary inferences arising from other facts before the court." Currently, a judge looks to the facts facts in the complaint, the attachments thereto, and perhaps to undisputed matters that may be the subject of judicial notice. To the extent that Petitioner's principle would permit judges to consider factual matters advanced by the *defendant,* in the motion to dismiss or otherwise, it

should be rejected. Congress gave no indication in the PSLRA that it intended such a jarring departure from long-settled practice. Indeed, Congress made provision in Rule 12(b) for considering materials in addition to the complaint by treating the motion as a motion for summary judgment under Rule 56. To authorize judges to transform a Rule 12(b)(6) motion into a trial by affidavit on the merits would clearly violate the Seventh Amendment.

There is similarly no statutory support for Petitioner's second "principle," that factual allegations of the defendant's motive are especially important, or even essential, to a securities fraud complaint. Congress neither prescribed nor prohibited any particular method of pleading scienter. To dismiss a complaint that does not allege motive but alleges other facts from which a jury could infer the requisite state of mind would deprive the plaintiff of the right to submit this factual question to the jury.

Finally, Petitioner would require factual allegations that yield not merely a "strong inference," but "the strongest of all possible inferences" of scienter. That is, if the alleged facts give rise to a strong inference that defendant acted with fraudulent intent, but may be viewed as yielding an equally strong inference of innocent intent, the complaint must be dismissed. There is no statutory text to support such a comparative test. It necessarily involves the judge in assessing the weight of competing inferences from facts, which is the responsibility of the jury.

Moreover, weighing competing inferences is not necessary to carry out the purpose of the PSLRA. Where, as here, allegations are ambiguous due to

missing facts, particularly facts within the control of the defendant, Rule 12(b) permits the judge to treat the motion as one for summary judgment and allow limited, focused discovery under Rule 56(f). The court could resolve the ambiguous factual allegations while protecting defendants against broad and unfocused "fishing expeditions."

ARGUMENT

I. THE COURT OF APPEALS APPLICATION OF THE HEIGHTENED PLEADING STANDARD OF THE PRIVATE SECURITIES LITIGATION REFORM ACT IS CONSISTENT WITH THE INTENT OF CONGRESS.

A. Congress Intended the Heightened Pleading Standard to Allow Early Dismissal of Baseless Lawsuits While Preserving the Viability of Meritorious Actions.

Pleadings, starting with the complaint, are the path to the courthouse. By 1938, common law and statutory code pleading had become an unacceptably intricate, often inscrutable puzzle. Litigants reached the courthouse, if at all, due to counsel's art, arcana and sheer good fortune, rather than the merits of their cases. *See generally*, Charles E. Clark, *Simplified Pleading*, 2 F.R.D. 456, 458-60 (1943).

The Rules of Civil Procedure greatly smoothed that path, requiring of the plaintiff only a "short and plain statement of the claim" for relief, sufficient to put the defendant on notice of the nature of the claim. Fed. R Civ. Pro. 8(a); *see Conley v. Gibson*, 355 U.S. 41, 47 (1957).

The Rules look instead to "summary judgment and control of discovery to weed out unmeritorious claims." *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 168-69 (1992). Rule 9(b) makes special provision for cases alleging fraud or mistake, requiring that "the circumstances constituting fraud or mistake shall be stated with particularity." Even in those cases, however, intent and other conditions of mind "may be averred generally." Fed. R. Civ. Pro. 9(b).

In 1995, finding that these Rules did not provide adequate protection for innocent defendants in private securities fraud lawsuits, Congress enacted the Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 ["PSLRA"]. Among other changes, Congress added new section 21D(b)(2) to Section 10(b) of the Securities Exchange Act of 1934 to impose heightened pleading requirements in private securities lawsuits.

Significantly, Congress was not concerned with improper or inordinately large or numerous jury verdicts. Indeed, Congress explicitly emphasized the value of such litigation:

> Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs.

H.R. Conf. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. at 730.[2]

Congress's aim was rather to "discourage frivolous litigation." *Id.* at 32, 1995 U.S.C.C.A.N. at 731. Specifically, the lawmakers saw the need for early dismissal of baseless "strike suits," described as

> the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action.

H.R. Conf Rep. No. 104-369, at 37, *reprinted in* 1995 U.S.C.C.A.N. at 736.

Defendants in such cases become the objects of "fishing expeditions," wide-ranging and costly discovery with no real basis for believing that evidence of fraud would be uncovered, but which "impose costs so burdensome that it is often economical for the victimized party to settle." *Id.* at 31, *reprinted in* 1995 U.S.C.C.A.N. at 730.

Such abusive lawsuits do not – and are not intended to – reach a jury for ultimate resolution. The evil Congress sought to address was the coercion of innocent defendants into settling such cases, based on the economics, not the merits, of their defense. *Id.*

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[2] This Court likewise recognizes that private suits further an "important securities law objective." "The securities statutes seek to maintain public confidence in the marketplace. They do so by deterring fraud, in part, through the availability of private securities fraud actions." *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 345 (2005) (citation omitted).

To rid the civil justice system of baseless suits prior to discovery, the PSLRA requires that a complaint alleging securities fraud under the Act specify "each statement alleged to have been misleading" along with "the reason or reasons why the statement is misleading." 15 U.S.C. § 78u-4(b)(1). In addition, the complaint must,

> with respect to each act or omission alleged to violate this chapter, state with particularity *facts giving rise to a strong inference* that the defendant acted with the requisite state of mind.

15 U.S.C. § 78u-4(b)(2) (emphasis added). All discovery is stayed while the motion is pending. 15 U.S.C. § 78u-4(b)(3)(B).

As Petitioner recognizes, "Congress 'sought to strike the appropriate balance between protecting the rights of victims of securities fraud and the rights of public companies to avoid costly and meritless litigation.'" Pet. Br. at 30 (quoting S. Rep. 104-98 at 10. Congress certainly intended "to permit the dismissal of frivolous cases at the earliest feasible stage of the litigation, thereby reducing the cost to the company, and by derivation, to its shareholders, in defending a baseless action." *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1278 (11th Cir. 1999).

Congress just as certainly did not mandate trial by affidavit for meritorious cases. Such an interpretation would not only contravene Congress's expressed intention that such litigation be encouraged, but would be a constitutionally suspect incursion on the litigant's right to trial by jury. As this Court emphatically stated:

> Our holding that the clear-and-convincing standard of proof should be taken into account in ruling on summary judgment motions does not denigrate the role of the jury. It by no means authorizes trial on affidavits. Credibility determinations, the weighing of the evidence, and the drawing of legitimate inferences from the facts are jury functions, not those of a judge, whether he is ruling on a motion for summary judgment or for a directed verdict. The evidence of the nonmovant is to be believed, and all justifiable inferences are to be drawn in his favor.

Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 255 (1986). *See also Poller v. CBS, Inc.*, 368 U.S. 464, 473 (1962) (Clark, J.) (summary procedures "should be used sparingly" in litigation "where motive and intent play leading roles [and] the proof is largely in the hands of the alleged conspirators. . . . Trial by affidavit is no substitute for trial by jury which so long has been the hallmark of 'even handed justice.'").

B. The Court of Appeals Struck the Proper Balance, Allowing Dismissal of Baseless Lawsuits While Preserving the Right to Trial By Jury For Meritorious Claims.

Congress left the application of its standard in particular cases to the federal courts. Section 78u-4(b)(2) neither prescribes nor prohibits the kinds of allegations or inferences that satisfy the heightened pleading standard for scienter. Nor does the text answer the very practical question facing judges, including the court in this case: How strong is a "strong inference"?

The answer articulated by the Seventh Circuit in this case is both precise and elegant. A securities fraud complaint satisfies the "strong inference" standard "if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602 (7th Cir. 2006).

The Solicitor General mischaracterizes this standard as equivalent to the standard before passage of the PSLRA. Br. for the United States at 23. To the contrary, the court of appeals carried out Congress's command to impose a far higher burden of fact pleading than courts had required under Rule 9(b), which allows fraudulent intent to be "averred generally." *See, e.g., In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1547 (9th Cir. 1994) ("[P]laintiffs may aver scienter generally . . . that is, simply by saying that scienter existed.").

The court of appeals' standard is readily familiar to federal judges, echoing the standard required to survive a motion for summary judgment under Rule 56 or, at a later stage, judgment as a matter of law under Rule 50. Such judicial dispositions will not lie "if the evidence is such that a reasonable jury could return a verdict for the nonmoving party." *Anderson*, 477 U.S. at 248. Nor may the case be taken from the jury "[i]f reasonable minds could differ as to the import of the evidence." *Id.* at 250. Federal courts have applied this standard in numerous cases. *See* 9A Wright & Miller § 2528, at 288-289 & nn.2-3 (2d ed. 1995) (judgment as a matter of law); *id.* at 10A, § 2713.1 (summary judgment).

The court of appeals' standard is strong enough to serve as a barrier to strike suits and fishing expeditions that do not allege facts from which a reasonable jury could find wrongful intent. A higher standard would not exclude any additional frivolous or groundless cases. At the same time, it is not so stringent as to dismiss meritorious claims that otherwise would be entitled to reach the jury, if supported by admissible evidence.

Nevertheless, Petitioner urges this Court to impose such a higher standard, one that would reword § 78u-4(b)(2) to require that the complaint demonstrate the "substantial merit" of plaintiff's claim of scienter. Pet. Br. at 23. Although Petitioner reiterates that phrase throughout its brief, Amicus is unable to discern that it offers any greater guidance to federal judges applying the statute. Nor does the Solicitor General's alternative, redefining "strong inference" to mean a "high likelihood" that defendant possessed the requisite scienter. Br. for the United States at 10, 15 & 20.

To the extent that these proposed formulations would result in dismissal of cases where "a reasonable person could infer that the defendant acted with the required intent," they raise a real danger of violating the jury right guaranteed by the Seventh Amendment, as the court below recognized. *See* 437 F.3d at 602.

II. THE COURT OF APPEALS' STANDARD IS CONSISTENT WITH THE SEVENTH AMENDMENT.

A. Seventh Amendment Is Implicated by Heightened Pleading Standards.

Amicus disagrees with Petitioner and the Solicitor General that "the Seventh Amendment is not implicated by the Reform Act" pleading requirements. Pet. Br. at 42. *See also* Br. for the United States at 29 ("Heightened pleading requirements have . . . not been thought to raise serious Seventh Amendment problems.").

The Solicitor General relies chiefly on this Court's decision in *Fidelity & Deposit Co. v. United States*, 187 U.S. 315 (1902). The United States sued Fidelity as a surety on a contract between a builder and a supplier that was allegedly breached. The applicable rule obliged the parties in contract actions to submit sworn affidavits including, from the defendant, an affidavit "specifically stating also, in precise and distinct terms, the grounds of his defense, which must be such as would, if true, be sufficient to defeat the plaintiff's claim." *Id.* at 318. Fidelity's affidavit raised no valid defense, but merely stated that it had no knowledge of the underlying contract, yet demanded a jury trial.

This Court's decision upholding judgment for the plaintiff does not suggest that pleading requirements do not raise Seventh Amendment concerns. First, the rule at issue in *Fidelity* was not one of heightened pleading requirements, but rather a rule authorizing summary judgment. Arthur R. Miller, *The Pretrial Rush to Judgment: Are the "Litigation Explosion," "Liability Crisis," and Efficiency Clichés Eroding Our Day in Court and Jury Trial Commitments?*, 78 N.Y.U.L. Rev. 982, 1018 (2003). Moreover, Justice McKenna, for the Court, recognized that Seventh Amendment concerns were implicated, declaring, "If it were true that the rule deprived the plaintiff in error of the *right* of trial

by jury, we should pronounce it void without reference to cases." 187 U.S. at 320. "But it does not do so," he added. Fidelity had simply failed to state the grounds of a defense that would make an issue for a jury to decide. *Id.*

Petitioner relies on *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986), where this Court "limit[ed] the range of permissible inferences" that a jury may draw under substantive antitrust law. The Court held that no reasonable jury could infer a predatory price-fixing conspiracy from evidence that would require the jury to find that defendants held prices below market level, losing money for more than two decades with no little prospect of controlling the market or even recovering their losses. Justice Powell, writing for the Court, stated that such an "implausible" claim, "one that simply makes no economic sense," could not support a finding of an illicit conspiracy under § 1 & § 2 of the Sherman Act. *Id.* at 587.

Petitioner fails to see *Matsushita's* key application to this case. If Congress or this Court were to elevate the substantive proof requirements (or narrow the permissible inferences) necessary for a reasonable jury to find for the plaintiff, a heightened pleading requirement that mirrored the heightened proof requirement would not infringe upon the right to a jury trial. For example, if Congress required that proof of fraudulent intent be established by clear and convincing evidence, a requirement that the complaint allege facts sufficient for a reasonable jury to find intent by clear and convincing evidence would deprive no plaintiff of the right to submit his or her case to the jury. *See Anderson v. Liberty Lobby*, 477 U.S. at 255-56.

The standard adopted by the court of appeals in this case is consistent with that view. The court of appeals did not hold that heightened pleading requirements necessarily violate the right to trial by jury. The conflict with the Seventh Amendment arises when, as Petitioner proposes, the pleading requirement imposes a higher burden than would be required to reach the jury under the substantive proof requirements. [3]

The Solicitor General recognizes this important point in a footnote at the end of his brief. The Solicitor General observes that if the Reform Act altered "not just the pleading standard but the substantive proof standard for scienter as well," that "would eliminate any Seventh Amendment concerns." Br. for the United States at 29 n.9.

But the PSLRA did not alter the proof requirements for establishing scienter under the Securities Act. Congress subsequently had occasion to clarify that point as it was considering the the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified as amended at 15 U.S.C. § § 77-78 (2000). The Conference Report stated:

> It is the clear understanding of the managers that Congress did not, in adopting the

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[3] This Court was careful to make this distinction between proof requirements and pleading requirements in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 346 (2005) ("Our holding about plaintiffs' need to *prove* proximate causation and economic loss leads us also to conclude that the plaintiffs' complaint here failed adequately to *allege* these requirements.") (emphasis in original).

> Reform Act, intend to alter the standards of liability under the Exchange Act.
>
> . . . [T]he clear intent in 1995 and our continuing intent in this legislation is that neither the Reform Act nor S. 1260 in any way alters the scienter standard in Federal securities fraud suits.

H.R. Conf. Rep. 105-803 at 15 (1998).

Even apart from such congressional statements, it is clear from the plain text of § 78u-4(b)(2) that Congress in enacting PSLRA "did not change the scienter that a plaintiff must prove to prevail in a securities fraud case but instead changed what a plaintiff must plead in his complaint in order to survive a motion to dismiss." *Helwig v. Vencor, Inc.*, 251 F.3d 540, 548 (6th Cir. 2001).

The pleading rule in this case does not affect "mere matters of form or procedure" governing trial by jury. *Baltimore & Carolina Line v. Redman*, 295 U.S. 654, 657 (1935). Rather, it touches upon the central purpose of the Seventh Amendment, to preserve "the common-law distinction between the province of the court and that of the jury, whereby . . . issues of law are to be resolved by the court and issues of fact are to be determined by the jury." *Id.*

"[B]ecause the federal courts operate under the strictures of the Seventh Amendment," this Court is reluctant "to take steps which ultimately might interfere with the proper role of the jury." *Browning-Ferris Industries v. Kelco Disposal*, 492 U.S. 257, 279 n.26 (1989). It is therefore a "cardinal principle" that, before inquiring into whether a statute violates the Seventh Amendment, the court should "first ascertain whether a construction is

fairly possible by which the [constitutional] question may be avoided." *Tull v. United States*, 481 U.S. 412, 417 n. 3 (1987) (citing *Curtis v. Loether*, 415 U.S. 189, 192 n. 6 (1974)).

The court of appeals' standard for "strong inference" fully carries out Congress's intent to allow dismissal of baseless lawsuits and at the same time avoids conflict with the fundamental right of the jury trial.

B. The Historic Importance of the Seventh Amendment Requires that Pleading Requirements Be Construed To Preserve the Right to Trial By Jury.

The "scope and effect of the Seventh Amendment . . . perhaps more than with any other provision of the Constitution, are determined by reference to the historical setting in which the amendment was adopted." *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 339 (1979) (Rehnquist, J., dissenting). Its importance can be seen in "the passion and violence with which the civil jury was defended during the Revolutionary era and the constitutional ratification debate." Alan Howard Scheiner, *Judicial Assessment of Punitive Damages, and the Politics of Jury Power*, 91 Colum. L. Rev. 142, 146-47 (1991).

On Sept 15, 1787, as the Constitutional Convention was nearing the end of its work in Philadelphia, the delegates took up a proposal that Article III include a guarantee that "trial by jury shall be preserved as usual in civil cases." The motion failed. Edith Guild Henderson, *The Background of the Seventh Amendment*, 80 Harv. L.

Rev. 289, 294 (1966). That omission nearly doomed ratification of the new Constitution.

The new Americans viewed trial by jury as essential to self-government and were passionately committed to it. They had bitterly resented England's transfer of civil disputes from colonial courts, where local juries sat, to Vice-Admiralty courts and other non-jury tribunals administered by the Crown's judges. See Roscoe Pound, THE DEVELOPMENT OF CONSTITUTIONAL GUARANTEES OF LIBERTY 69-72 (1957). Their list of grievances against the King, justifying their break with England, included "depriving us, in many cases, of the Benefits of Trial by Jury." Declaration of Independence ¶ 20 (1776). "The struggle over jury rights was, in reality, an important aspect of the fight for American independence and served to help unite the colonies." Stephan Landsman, *The Civil Jury In America: Scenes From an Unappreciated History,* 44 Hastings L.J. 579, 596 (1993).

For that reason, many in the founding generation denounced the proposed constitution as a betrayal that implicitly abolished the civil jury, and they demanded a Bill of Rights that would preserve the civil jury from encroachment by federal judges. *See Gasperini v. Center for Humanities, Inc.,* 518 U.S. 415, 450-51 (1996) (Scalia, J., dissenting); Henderson, 80 Harv. L. Rev. at 295.

Alexander Hamilton, recognizing that the absence of a right to trial by jury in civil cases was the leading popular objection to ratification in New York and other states, sought to reassure the public that "friends and adversaries of the plan of the convention, if they agree in nothing else, concur at least in the value they set upon the trial by jury."

The Federalist No. 83, at 495 (Clinton Rossiter ed. 1961). James Iredell, campaigning for ratification of the Constitution in North Carolina, argued that any representative in Congress who, out of "folly or insanity," sought to infringe the jury right "soon would be taught the consequence of sporting with the feelings of a free people." James Iredell, Marcus, Answers to Mr. Mason's Objections to the New Constitution (1788), in 5 THE FOUNDERS' CONSTITUTION 357-358 (Philip B. Kurland & Ralph Lemer eds. 1987).

Nevertheless, as Justice Story later recounted, popular demand for a jury guarantee in the Constitution was "well-nigh preventing its ratification." Joseph Story, COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES 653 (R. Rotunda & J. Nowak eds. 1987) (1833). Only after the Federalists agreed to add a Bill of Rights containing such a guarantee did the Constitution win ratification. Henderson, 80 Harv. L. Rev. at 295-98; Scheiner, 91 Colum. L. Rev. at 146-47. As Justice Story relates,

> As soon as the constitution was adopted, this right was secured by the seventh amendment of the constitution proposed by congress; and which received an assent of the people, so general, as to establish its importance as a fundamental guarantee of the rights and liberties of the people.

Parsons v. Bedford, 28 U.S. (3 Pet.) 433, 445 (1830).

The possible loss of the right to trial by jury aroused such passions because the Founders viewed it as far more than a mere mode of civil procedure. The civil jury and service on the jury was a political right of immense importance, often equated with

self-government and the right to vote. *See, e.g.*, Vidram David Amar, *Jury Service as Political Participation Akin to Voting*, 80 Cornell L. Rev. 203, 218 (1995); Akhil Reed Amar, *The Bill of Rights as a Constitution,* 100 Yale L.J. 1131, 1186-96 (1991).

The Founders considered it a "bulwark against tyranny and corruption, a safeguard too precious to be left to the whim of the sovereign, or, it might be added, to that of the judiciary." *Parklane Hosiery Co. v. Shore,* 439 U.S. 322, 343 (1979) (Rehnquist, J., dissenting). Jefferson regarded the jury as "the only anchor . . . by which a government can be held to the principles of its constitution." 3 The Writings of Thomas Jefferson 71 (Washington ed. 1861).

The Founders also looked upon the civil jury as a shield against oppression by private moneyed interests. Scheiner, 91 Colum. L. Rev. at 152. In particular, farmers, Revolutionary War veterans, and others who found themselves in debt relied upon local juries drawn from their communities to ameliorate the harshness of the commercial law in the hands of judges. Charles W. Wolfram, *The Constitutional History of the Seventh Amendment,* 57 Minn. L. Rev. 639, 671-77 (1973).

The Framers expected that "the jury would reach a result that the judge either could not or would not reach." Wolfram, *supra*, at 671. They adopted the Seventh Amendment to preserve the jury's right to do so.

The court of appeals set its standard for "strong inference" at a level that fully carries out Congress's intent to allow courts to dismiss baseless lawsuits. Indeed, it is unlikely that a higher standard – one that would dismiss allegations that,

if proved, would support a verdict for the plaintiff – would eliminate any additional "strike suits," "fishing expeditions," or coerced settlements by innocent defendants. Moreover, the court was mindful of this Court's admonition:

> Maintenance of the jury as a fact-finding body is of such importance and occupies so firm a place in our history and jurisprudence that any seeming curtailment of the right to a jury trial should be scrutinized with the utmost care.

Dimick v. Schiedt, 293 U.S. 474, 486 (1935).

III. PETITIONER'S PROPOSED "PRINCIPLES" FOR REVIEWING PLEADINGS FOR A "STRONG INFERENCE" OF SCIENTER ARE CONTRARY TO THE STATUTORY TEXT AND THE SEVENTH AMENDMENT.

Perhaps recognizing that its "substantial merit" standard offers little concrete help to judges assessing the scienter allegations in a securities fraud complaint, Petitioner also urges this Court to engraft three additional "principles" onto § 78u-4(b)(2): That the court consider contrary inferences from facts outside the complaint, that the complaint allege facts demonstrating motive, and that plaintiff's inference of scienter be stronger than any competing inferences from the alleged facts. Pet. Br. at 34. Amicus suggests that none of these "principles" finds any support in the statutory text and that all infringe upon the role of the jury.

A. The Sufficiency of the Complaint Should Be Based On Plaintiff's Factual Allegations.

Petitioner would first require that the judge passing upon a motion to dismiss a securities fraud complaint "take into consideration all the facts and allegations that bear on the question, not just those facts or inferences that might be viewed as favoring the plaintiff's charge," with respect to scienter, but also "contrary inferences arising from other facts before the court." Pet. Br at 34.

One commentator has observed that "the whole idea of deciding pleadings motions on the basis of extraneous materials rather than the allegations of the complaint not only deviates from the prior practice but startles legal sensibilities." Richard L. Marcus, *The Puzzling Persistence of Pleading Practice,* 76 Tex. L. Rev. 1749, 1757 (1998). It is true that some courts have allowed judges to consider materials in addition to the complaint and the documents attached thereto,[4] where the facts are not subject to dispute. *See, e.g., Allen v. WestPoint-Pepperell, Inc.,* 945 F.2d 40, 44 (2d Cir. 1991) (a court must confine its consideration "to facts stated on the face of the complaint, in documents appended to the complaint or incorporated in the complaint by reference, and to matters of which judicial notice may be taken"); *Fecht v. Price Co.,* 70 F.3d 1078, 1080 n.1 (9th Cir. 1995) (proper to consider a document whose contents were alleged in the complaint and whose authenticity is not challenged).

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[4] Documents attached to the complaint are deemed to be a part of the pleading for all purposes. Fed. R. Civ. Pro. 10(c).

Petitioner, however, phrases its principle much more broadly, insisting that "courts must look at everything, taken together, to determine whether an assertion of scienter is weak and speculative" in light of "the entirety of what is before the court." Pet. Br. at 35. To the extent that Petitioner's "principle" would authorize judges to take into consideration factual allegations put before the court by the defendant, in the motion to dismiss or otherwise, it must be rejected.

Prior practice under both the common law and code pleading rules outlawed the "speaking demurrer" in which the defendant sought to make affirmative allegations tending to show that no cause of action was stated. Marcus, *supra*, at 1757.

Indeed, Congress has already made provision for consideration, on a motion to dismiss or for judgment on the pleadings, of materials in addition to the complaint. In that circumstance the motion is treated as a motion for summary judgment and is governed by Rule 56.[5]

It is fair to assume that, in the absence of any indication to the contrary, Congress intended that motions to dismiss under the PSLRA would continue to be governed in this fashion.

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[5] Fed. R. Civ. Pro. 12(b) provides:

> If, on a motion asserting the defense numbered (6) to dismiss for failure of the pleading to state a claim upon which relief can be granted, matters outside the pleading are presented to and not excluded by the court, the motion shall be treated as one for summary judgment and disposed of as provided in Rule 56.

See also Fed. R. Civ. Pro. 12(c), making the same provision for motions for judgment on the pleadings.

Regardless of whether an inference that tends to negate scienter is based on the facts alleged in the complaint or on "other facts before the court," Petitioner's "principle" undermines another, more fundamental principle: The facts alleged in the complaint are deemed to be true for purposes of the motion to dismiss under Rule 12(b)(6) and all inferences are to be drawn in plaintiff's favor. Charles Alan Wright, et al., FEDERAL PRACTICE AND PROCEDURE § 1363 (3d ed. 1998) (collecting cases).

A concrete example is Petitioner's own application of its principle to this case. Petitioner argues strenuously that Plaintiff's inference that Notebaert intentionally or recklessly exaggerated sales and demand for the company's products is rendered "extraordinarily weak, if not nonexistent" by the fact that during March and April 2001, Notebaert announced downward revisions of the company's revenue projections. Pet. Br. at 36 & 47-48. The court of appeals viewed these inferences as far weaker than defendant asserts. The court noted that the March revision was "modest" and "was attributable to lower-than-expected growth in Tellabs's CABLESPAN® business, a product unrelated to this action." 437 F.3d at 592. In announcing the April 6 revision, "Notebaert insisted that the demand for the TITAN 6500 was "very strong" and explained that the only reason for the downward projections was that Tellabs's customers were pushing orders back from the first to the second quarter of 2001." *Id.* at 593.

Where the complaint alleges facts from which a reasonable jury could infer scienter, it is the exclusive province of the jury to determine whether

plaintiff's showing is outweighed by other inferences, or inferences from other facts.

B. Factual Allegations of Defendant's Motive To Engage In Fraud Are Not Essential To Plead Scienter.

As a second principle, Petitioner contends that allegations of the defendant's motive to engage in fraud are crucial to surviving a motion to dismiss. In this case, for example, in the absence of a factual allegation "that Notebaert personally benefited financially," the inference of willfulness or recklessness in making false statements cannot be "strong." Pet. Br. at 50.

The text § 78u-4(b)(2) gives no indication that factual allegations regarding motive are required. Indeed, "the words of the Act neither mandate nor prohibit the use of any particular method to establish an inference of scienter." *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195-96 (1st Cir. 1999).

Congress explicitly adopted the "strong inference" standard from the case law of the Second Circuit. Prior to passage of the PSLRA, the Second Circuit had required under Rule 9(b) that a securities fraud complaint allege facts giving rise to a "strong inference of fraudulent intent." *See Ross v. A.H. Robins Co.*, 607 F.2d 545, 558 (2d Cir. 1979). The Second Circuit had also held that a complaint met the "strong inference" standard by alleging *either* the defendant's motive and opportunity to commit fraud or other circumstantial evidence of scienter. *See In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268-69 (2d Cir. 1993).

The Senate Committee indicated that by adopting the Second Circuit's "strong inference"

standard, it "does not intend to codify the Second Circuit's case law interpreting this pleading standard." though it added that "courts may find this body of law instructive." S. Rep. No. 104-98 at 15 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679 at 694. The Conference Committee likewise disclaimed any intent to codify Second Circuit case law. *See* H.R. Conf. Rep. No. 104-369, at 41 (1995). According to Senator D'Amato, who managed the PSLRA on the floor of the Senate, Congress did not wish "to say precisely what evidence a party may present to show a strong inference of fraudulent intent. I think this strait-jackets the court." 141 Cong. Rec. S9201 (daily ed. June 28, 1995) (statement of Sen. D'Amato).

Accordingly, most courts hold it "sufficient for plaintiffs [to] plead scienter by alleging facts establishing a motive and an opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior." *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3d Cir. 1999); *accord*, *Press v. Chem. Inv. Services, Corp.*, 166 F.3d 529, 538 (2d Cir. 1999). *See also Helwig*, 251 F.3d 540, 551 (6th Cir. 2001) ("Congress did not endorse or prohibit a particular manner of pleading").

If Congress had instead intended to place a premium on particularized pleading regarding defendant's motive to an extent beyond even the most stringent pleading requirements of any circuit, it would have done so explicitly.

As a practical matter, while evidence of a personal financial motive is relevant to fraudulent intent, the absence of such evidence, particularly prior to discovery, does not point strongly to innocence. The absence of an allegation of a financial

motive does not, as Petitioner states, require the court "to infer that the defendant engaged in wrongdoing for the sheer joy of it, rather than for profit." Pet. Br. at 36. A corporate executive engaging in securities fraud may well take steps to disguise or hide his own trading from public view.

A plaintiff who has not unearthed evidence of personal trading activity, but can allege sufficient other circumstantial evidence yielding a strong inference of fraudulent intent, should not be dismissed on the basis of an artificial "principle" of pleading.[6]

C. The Inference of Scienter Need Not Be the Strongest Possible Inference From the Alleged Facts.

As a third principle, Petitioner argues that an inference of scienter cannot be "strong" if "the claimed culpable inference appears no more plausible than alternative, innocent inferences." Pet. Br. at 37. In other words, if equally strong opposing inferences may be drawn from plaintiff's alleged facts, the case must be dismissed. The Solicitor General espouses the same position. *See* Br. for the United States at 26 ("Plainly, therefore, if the alleged facts give rise to two seemingly equally strong [competing] inferences, a court must conclude that the inference of scienter is not itself 'strong.'") (internal quotation and citation omitted).

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[6] In *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986), on which Petitioner relies, this Court specified that the lower court was free to consider other evidence that would permit the finder of fact to find that defendants conspired to hold down prices "despite the absence of any apparent motive." *Id.* at 597.

This "principle" does considerable violence to the statutory text, rewriting "strong inference" to mean the "strongest possible inference."

As the court of appeals indicated, such a gloss on the pleading requirement also infringes upon a plaintiff's right to trial by jury. If the alleged facts would support a jury finding of scienter, the plaintiff is entitled to reach the jury, regardless of the judge's view that a different interpretation of the facts is as strong. *See* 437 F.3d at 602. The Tenth Circuit has taken the same view:

> Faced with two seemingly equally strong inferences, one favoring the plaintiff and one favoring the defendant, it is inappropriate for us to make a determination as to which inference will ultimately prevail, lest we invade the traditional role of the factfinder.

Pirraglia v. Novell, Inc., 339 F.3d 1182, 1188 (10th Cir. 2003).

Petitioner does not directly address this clear transgression of the boundary between the roles of the judge and jury. Instead, Petitioner seeks support for its principle in two decisions by this Court reviewing summary judgment rulings in antitrust cases: *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986), and *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752 (1984). Neither supports the notion that the judge may take from the jury a case in which a reasonable jury could find for the plaintiff.

This Court ruled in *Matsushita* that ordinary, possibly innocent actions by defendants, such as setting prices at a level that took business away from competitors, does not, by itself give rise to any

inference under substantive antitrust law that they were engaged in a predatory pricing conspiracy. 475 U.S. at 588. Without additional evidence that would permit a jury to find the existence of a conspiracy, there was no issue of material fact for the jury, and summary judgment was appropriate. *Id.* at 597-98.

Similarly, the Court in *Monsanto* ruled that the possibly innocent act of terminating a low-price distributor following complaints by other distributors does not, standing alone, give rise to an inference of an illegal conspiracy. In *Monsanto,* however, there *was* additional evidence supporting plaintiff, including statements in a company newsletter and testimony regarding the distributors' complaints. Defendant Monsanto drew the opposite inference from the newsletter and testimony: that Monsanto acted innocently. This Court responded, "The interpretation of these documents and the testimony surrounding them properly was left to the jury." *Id.* at 766 n.11. The Court added, "The choice between two reasonable interpretations of the testimony properly was left for the jury." 767 n.12.

Moreover, Petitioner's principle is unnecessary to carry out Congress's purpose in enacting the PSLRA, as its application in this case shows.

Petitioner attributes conflicting inferences to "ambiguous pleadings" by plaintiffs. As examples, Petitioner points to the allegation that Notebaert gave upbeat sales projections in March 2001 for the TITAN 5500, though the company-commissioned Probe Research Report, completed in "early 2001," indicated weakening sales. Pet Br at 46. The complaint also alleged that Notebaert's March 8, 2001 statements were knowingly false in view of the information contained in a "March 2001" internal

report. Pet. Br at 47 n.22. Both allegations are ambiguous, Petitioner contends, because the complaint does not indicate whether the documents had been completed and read by Notebaert prior to making the allegedly misleading statements. Pet. Br. at 46 & 47 n.22.

These and other examples cited by Petitioner are ambiguous because important facts are missing – facts that, as is often the case – are in the exclusive control of the defendant. Petitioner argues that dismissal is required to serve "the core purpose of the Reform Act." Pet. Br. at 37.

To the contrary, as Professor Marcus explains, this is the kind of case in which dismissal is *not* necessary. Rule 12(b) allows the court to treat the motion as one for summary judgment, to give the parties "reasonable opportunity" to present pertinent material, and, under Fed. .R. Civ. Pro. 56(f), to permit limited discovery. By focusing discovery on the specific allegations at issue, such as the date the defendant received a particular document, the court can eliminate the risks of broad, expensive discovery and "fishing expeditions." Richard L. Marcus, *The Revival of Fact Pleading under the Federal Rules of Civil Procedure*, 86 Colum. L. Rev. 433, 488-90 (1986). It is not necessary for the court to become involved in the weighing of competing inferences to accomplish the purposes of the PSLRA.

* * *

Within living memory of the adoption of the Seventh Amendment, Justice Story declared: "The trial by jury is justly dear to the American people. It has always been an object of deep interest and solicitude, and every encroachment upon it has been

watched with great jealousy." *Parsons v. Bedford*, 28 U.S. (3 Pet.) 433, 446 (1830).

The threat in modern times, Justice Hugo Black and Chief Justice William Rehnquist have both warned, is not outright elimination of the jury but "the gradual process of judicial erosion" of the Seventh Amendment guarantee under the guise of interpreting procedural rules. *Parklane Hosiery Co., Inc. v. Shore, supra, at* 339 (1979) (Rehnquist, J., dissenting), quoting *Galloway v. United States*, 319 U.S. 372, 397 (1943) (Black, J., dissenting). Amicus urges this Court to uphold the Seventh Circuit's fealty to the constitutional command that "the right of trial by jury shall be preserved." U.S. Const. amend. VII.

CONCLUSION

For the above reasons, the decision of the court of appeals below should be affirmed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

TELLABS, INC., ET AL.,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,

Respondents.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Seventh Circuit

BRIEF FOR THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, BDO SEIDMAN, LLP, DELOITTE & TOUCHE USA LLP, ERNST & YOUNG LLP, GRANT THORNTON LLP, KPMG LLP, AND PRICEWATERHOUSECOOPERS LLP AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF AMICI CURIAE*

Amici curiae include the American Institute of Certified Public Accountants (AICPA), the national organization of the certified public accounting profession. The AICPA's nearly 340,000 members, all of whom are certified public accountants, provide accounting services to companies through firms of all sizes, as solo practitioners, and as employees of companies, governments, and academic institutions. Among the AICPA's most important roles is the promotion and maintenance of high professional standards among its members. To this end, the AICPA has been a principal force in developing accounting and auditing standards, drafting model legislation, sponsoring educational programs, and issuing professional publications to improve the quality of the services provided by accountants. The AICPA also has a strong interest in judicial decisions affecting the scope and bases of accountants' liability under the federal securities laws, and has participated as *amicus* in some of this Court's most significant securities-fraud cases. *See, e.g.*, *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336 (2005); *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

Amici also include America's leading accounting firms: BDO Seidman, LLP, Deloitte & Touche USA LLP, Ernst & Young LLP, Grant Thornton LLP, KPMG LLP, and PricewaterhouseCoopers LLP. Collectively, these *amici* provide audit services to most of the publicly owned companies whose shares are traded on American exchanges. As a result of their audit engagements, accountants are regularly named as defendants in private lawsuits filed under the federal securities laws. Accordingly, *amici* have a keen interest in cases,

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*This brief was not authored, in whole or in part, by counsel for either party, and no person or entity other than *amici*, their members, and their counsel contributed monetarily to the preparation or submission of the brief. The parties have consented to the filing of the brief and copies of their letters of consent have been lodged with the Clerk of the Court.

such as this one, concerning the standards required to plead and prove a securities-fraud violation. Accounting firms have previously participated in such cases in this Court, either as *amici*, *e.g.*, *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988), or as parties, *e.g.*, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

The present case concerns the pleadings standards established by the Private Securities Litigation Reform Act of 1995 (PSLRA). In the PSLRA, Congress required securities-fraud plaintiffs to plead particularized facts leading to a "strong inference" that each defendant acted, or failed to act, with the requisite "*scienter*"—the culpable mental state necessary to establish liability under the federal securities laws. 15 U.S.C. § 78u-4(b)(2). This rigorous pleading standard is of particular importance to secondary actors such as auditors, who often are targeted when those more centrally involved in the alleged misconduct are unavailable or have become judgment-proof. *See* S. Rep. No. 98, 104th Cong., 1st Sess. 9 (1995) ("Underwriters, lawyers, accountants, and other professionals are prime targets of abusive securities lawsuits. The deeper the pocket, the greater the likelihood that a marginal party will be named as a defendant in a securities class action.").

SUMMARY OF ARGUMENT

To discourage frivolous securities-fraud litigation, Congress requires private plaintiffs to plead "with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added).

I. The plain language of the PSLRA—which requires a "strong inference" of *scienter*—imposes meaningful constraints on a private plaintiff attempting to plead a securities-fraud case. An "inference" is a conclusion drawn from facts assumed be true. "Strong" in this context means "cogent" or "convincing." Reading the PSLRA in light of these definitions, the plaintiff must plead particularized facts that, if proven, lead convincingly to the conclusion that the defen-

dant acted with *scienter*. This construction has two corollaries.

First, to be "strong," an inference must be more than merely plausible or possible. Rather, the plaintiff must plead facts from which a reasonable person would be convinced of the defendant's mental state. This can be considered an *absolute* constraint on the pleading.

Second, to be "strong," an inference must be free of significant doubt. Rather, the plaintiff must plead facts from which a reasonable person would be convinced of the defendant's culpable mental state despite—or when compared to—alternative innocent explanations. This can be considered a *relative* constraint on the pleading.

Both the absolute and the relative constraints on the pleading are implicit in the words used by Congress and are necessary to give effect to the statutory standard of "strong inference." A particular inference of *scienter* might be plausible, but unlikely; such an inference would not be "strong" in the absolute sense. Likewise, an inference could be likely, but no more likely than the alternatives; such an inference would not be "strong" in the relative sense. Thus, to satisfy the "strong inference" standard of the PSLRA, the particularized facts must give rise to an inference of *scienter* that is both (absolutely) likely and (relatively) more likely than competing non-culpable inferences.

II. The policies that led Congress to enact the PSLRA support imposition of meaningful constraints on the pleading. Congress sought to prevent and deter meritless "strike suits." Imposing an absolute threshold on securities plaintiffs will further the congressional objective by precluding suits in which intentional misconduct is not a forceful conclusion from available evidence. Similarly, imposing a relative check will preclude suits in which the plaintiffs' theory is placed into significant doubt by the available alternative explanations.

Meaningful constraints are of particular importance in claims against peripheral actors such as auditors, who often

are targeted when those more directly responsible for the alleged misconduct are unavailable or have become judgment-proof. Congress was concerned about the impact of vexatious litigation on secondary actors such as accounting firms when it passed the PSLRA. The audit process involves the application of judgment to complex, and potentially competing, accounting pronouncements. To effectuate Congress's intent in enacting the PSLRA, a plaintiff suing an auditor must plead facts that, if proven, would convince a reasonable person both that the auditor departed from the wide zone of discretion afforded under applicable professional standards and that such departure was made with the requisite mental state. Absent particular facts from which a reasonable person should *strongly infer* intentional misconduct, accounting firms and others should not face the crippling expense of defending against securities lawsuits.

III. Giving full effect to the pleading requirements imposed by the PSLRA creates no concern under the Seventh Amendment. Consistent with its power to define what type of securities-fraud claims can be redressed in federal court and to legislate the "forms and procedure" for litigation in federal court, Congress may establish evidentiary and pleading standards that a plaintiff must meet *before* its case is submitted to the jury. That is precisely what Congress did in setting the "strong inference" threshold for access to federal court by securities plaintiffs. Enforcing that threshold by requiring that the inference raised by a plaintiff's allegations is, in fact, "strong" presents no constitutional difficulty.

ARGUMENT

Most private securities lawsuits allege a violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5. Securities fraud under the statute and rule is an intentional tort; negligent conduct is not actionable. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214-15 (1976). As this Court recently emphasized, a required element in a 10b-5 action is

"*scienter*, *i.e.*, a wrongful state of mind." *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336, 341 (2005).

Securities-fraud claims against auditors are typically premised on the auditors' alleged failure to detect a fraud allegedly committed by the public company audit client, with the result that the auditors' report on the company's financial statements is said to be false. But errors in the financial statements do not in themselves establish that the auditors departed from the requisite standard of care in auditing those statements, much less that they did so with *scienter*. Nonetheless, claims of "audit failure" are easy to make, and are extremely costly for auditors to defend against. As this Court has observed, "[l]itigation under 10b-5 . . . requires secondary actors to expend large sums even for pretrial defense and the negotiation of settlements." *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 189 (1994) (highlighting statements in the congressional record that in 83% of Rule 10b-5 cases major accounting firms pay $8 in legal fees for every $1 paid in claims). When such "peripheral defendants are sued, the pressure to settle is overwhelming—regardless of the defendant's culpability." S. Rep. No. 98, 104th Cong., 1st Sess. 21 (1995).

Concluding that the "private securities litigation system is too important to the integrity of American capital markets to allow this system to be undermined by those who seek to line their own pockets by bringing abusive and meritless suits," Congress enacted the PSLRA in 1995 to "implement[] needed procedural protections to discourage frivolous litigation." H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 31-32 (1995); *see, e.g.*, *Behlen* v. *Merrill Lynch*, 311 F.3d 1087, 1091 (11th Cir. 2002), *cert. denied*, 539 U.S. 927 (2003); *Lander* v. *Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 107 (2d Cir. 2001). One of the PSLRA's most significant reforms was the creation of new and rigorous pleading requirements for private securities fraud actions. 15 U.S.C. § 78u-4; *see, e.g.*, *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 978-79 (9th Cir. 1999); Christopher M. Fairman,

Heightened Pleading, 81 Tex. L. Rev. 551, 600 (2002) ("Congressional motivation for enacting the [heightened pleading standards of the] PSLRA was [that] . . . private securities fraud litigation was seen as largely frivolous").

With respect to *scienter*, the PSLRA requires a civil plaintiff to plead "with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added). Construing this provision, the Seventh Circuit held that it "will allow the complaint to survive if it alleges facts from which, if true, a reasonable person *could* infer that the defendant acted with the required intent." Pet. App. 20a (emphasis added). The Seventh Circuit also refused to consider competing inferences in evaluating the sufficiency of the complaint. *Id.* at 20a-21a. As explained below, the Seventh Circuit got it wrong.

I. The Plain Language Of The PSLRA Requires That The Scienter "Inference" Be "Strong"

In construing a statute, this Court begins, of course, with the plain language of the statute. *Connecticut Nat'l Bank* v. *Germain*, 503 U.S. 249, 253-54 (1992). Congress used a particular formulation—"strong inference"—in describing the conclusion a reasonable person would have to draw from particularized factual allegations in order for a securities-fraud complaint to survive a motion to dismiss. Where, as here, Congress uses ordinary words, this Court will give them their ordinary meaning. *FDIC* v. *Meyer*, 510 U.S. 471, 476 (1994).

An inference is "a truth or proposition drawn from another which is admitted or supposed to be true," or "a logical conclusion from given data or premises." *Webster's New International Dictionary* 1273 (2d ed. 1949); *see also, e.g.*, *Black's Law Dictionary* 793 (8th ed. 2004) (a "conclusion reached by considering other facts and deducing a logical consequence from them"); *Merriam-Webster's Collegiate Dictionary* 598 (10th ed. 1996) ("the act of passing from one

proposition . . . considered as true to another whose truth is believed to follow from that of the former").

When referring to an argument or evidence, "strong" means "powerful[,] forcible[,] [or] cogent." *Webster's*, *supra*, at 2499; *see also*, *e.g.*, *Black's Law Dictionary* 1423 (6th ed. 1990) ("cogent, powerful, forcible, forceful"); *Merriam-Webster's*, *supra*, at 1166 ("forceful" or "cogent"). "Cogent," in turn, means "convincing or strongly tending to convince," or "compelling." *Webster's*, *supra*, at 520. And "convincing" means "[s]atisfying or assuring by argument or proof." *Id.* at 584.

Reading the PSLRA in light of these definitions, the plaintiff must plead particularized facts that, if proven, lead convincingly to, or "compel," the conclusion that the defendant acted with the requisite mental state. This construction has two important corollaries.

First, a "strong inference"—a proposition that convincingly follows from the factual allegations—must be more than merely plausible or possible. Rather, a plaintiff must plead facts from which, if true, a reasonable person would be *convinced* ("satisf[ied] or assur[ed]") that the defendant had the requisite mental state. This can be considered an *absolute* constraint on the pleading—that is, regardless of the strength or weakness of other possible inferences, the plaintiff's proposed inference must, on its own terms, be "strong."

It is not enough, as the Seventh Circuit thought, for a plaintiff to plead facts from which a jury "could infer" *scienter*. Such a standard means only that the complaint contains allegations from which, if proven, a rational trier of fact *might* conceivably infer that the defendant acted intentionally—but might not. This merely restates the standard under pre-PSLRA law, which provided that a complaint would be sustained if the allegations raised *an* inference of *scienter*. *Conley* v. *Gibson*, 355 U.S. 41, 45-46 (1957) (motion to dismiss should not be granted "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief"). Congress clearly

intended the PSLRA to impose a *higher* pleading standard in securities-fraud actions. But the Seventh Circuit's "could infer" formulation does not give effect to the changes wrought by Congress in enacting the PSLRA, particularly the statutory requirement that the plaintiff must plead specific facts giving rise to a *strong* inference of the requisite mental state, and thus impermissibly renders the PSLRA's "strong inference" standard superfluous. *Pennsylvania Dep't of Pub. Welfare* v. *Davenport*, 495 U.S. 552, 562 (1990) ("Our cases express a deep reluctance to interpret a statutory provision so as to render superfluous other provisions in the same enactment"); *United States* v. *Menasche*, 348 U.S. 528, 538-39 (1955) ("It is our duty 'to give effect, if possible, to every clause and word of a statute'") (citation omitted).

Where securities plaintiffs have not alleged anything that convincingly shows *scienter*, they cannot rest on that non-allegation. In *PR Diamonds, Inc.* v. *Chandler*, 364 F.3d 671 (6th Cir. 2004), for example, the plaintiffs alleged that auditors acted with *scienter* in failing to discover that the accounts receivable reserve was understated, because the auditors could see that in the particular year, revenue increased by 8 percent but the accounts receivable increased by 14 percent. *Id.* at 693. Of course, absent more, an increase in accounts receivable relative to revenue is equally consistent with an accurate reserve, so the court held that the facts did not give rise to an adequate allegation of *scienter* because plaintiffs made "no specific allegation that [the auditors] knew that certain accounts were not collectible." *Id.* at 695. That conclusion was unquestionably correct. *Cf. Associated Gen. Contractors* v. *California State Council of Carpenters*, 459 U.S. 519, 526 (1983) ("It is not . . . proper to assume that [a plaintiff] can prove facts that it has not alleged or that the defendants have violated the antitrust laws in ways that have not been alleged").

A recurrent problem in securities-fraud cases is that allegations might raise, at best, only a *weak* inference of *scienter*. For instance, companies and their auditors are often sued

based on the mere presence of an accounting mistake and an allegation that the mistake must have been made (or concealed) intentionally because of the desire for continued or increased financial rewards. But such an inference of *scienter*, if accepted, would lead to the absurd result that all people who fear losing their job would be deemed to have an intent to defraud, deceive or manipulate. *See, e.g., Acito* v. *Imcera Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995) ("Plaintiffs' allegation that defendants were motivated to defraud the public because an inflated stock price would increase their compensation is without merit. If scienter could be pleaded on that basis alone, virtually every company in the United States that experiences a downturn in stock price could be forced to defend securities fraud actions."); *Shields* v. *Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994) ("To allege a motive sufficient to support the inference [of fraudulent intent], a plaintiff must do more than merely charge that executives aim to prolong the benefits of the positions they hold").

Accounting firms have even less direct financial incentive to commit or condone fraud than those who manage a company and whose compensation might be closely tied to reported profits or increases in stock price. Indeed, auditors have little to gain but much to lose by not exposing a client's fraud—*i.e.*, by issuing a misleading audit report. *See, e.g., DiLeo* v. *Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) ("An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years' audits could not approach the losses [the accountant] would suffer from a perception that it would muffle a client's fraud."); *Melder* v. *Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994) (rejecting as "economically irrational" plaintiff's proposed *scienter* inference based on accounting firm's purported motive to garner fees). An auditor's receipt of its normal fees thus raises no inference of intentional misconduct. *A fortiori*, the congressional requirement of a "strong inference" cannot be met by such allegations. The same is true with respect to other routine aspects of the audit process,

such as the auditors' access to the books and records of a corporation.

Second, to be "convincing," a proposition must be free of significant doubt. *See Webster's*, *supra*, at 584 ("[t]o convince" means "to bring by argument to yield assent or have belief beyond doubt"); *Oxford English Dictionary* 879-80 (2d ed. 1989) ("convincing" means evidence that "brings conviction to the mind"; a "conviction" is a "strong belief on the ground of satisfactory reasons or evidence"). Accordingly, a plaintiff's proposed inference must be compelling despite—or when compared to—alternative explanations, including those raised by the absence of factual averments. This does not mean, of course, that plaintiffs must prove an inference beyond any reasonable doubt. But the doubt cannot be *as* plausible as the inference, otherwise the inference could not be said to follow from the alleged facts. It cannot be at the same time true that one is both "convinced" and also has significant doubt about a given proposition, such as whether the defendant acted with the requisite mental state. This can be considered a *relative* constraint on the pleading—that is, the court cannot exclude or ignore the doubt raised by alternative inferences in evaluating whether the inference raised by the plaintiff's allegations is "strong."

Indeed, this Court has already recognized that a plaintiff must show that the inference of *scienter* is "reasonable in light of the *competing inferences* of [innocent] action" that can also be drawn from the given facts. *Matsushita Elec. Indus. Co.* v. *Zenith Radio Corp.*, 475 U.S. 574, 588 (1986) (emphasis added). *Matsushita* relied on *Monsanto Co.* v. *Spray-Rite Service Corp.*, 465 U.S. 752 (1984), which had held "that conduct as consistent with permissible competition as with illegal conspiracy does not, standing alone, support an inference of antitrust conspiracy." *Matsushita,* 475 U.S. at 588. Accordingly, *Matsushita and Monsanto* teach that, in determining intent based on circumstantial evidence, competing inferences must be weighed.

Although *Matsushita* and *Monsanto* were antitrust cases, it was the requirement of intentional conduct and not the nature of the underlying claim that limited the range of permissible inferences. *Monsanto* explained that "[t]o permit the inference of *concerted* action" on the basis of conduct that is equally consistent with independent action would "emasculate the terms of the statute." 465 U.S. at 764 (internal quotation marks omitted, alteration in original). That is, the term "concerted" would be read out of the statute if one could reasonably infer, from the anti-competitive effect of an action, that the action was "in concert" (*i.e.*, that there was anti-competitive intent) notwithstanding that the given facts equally support an "inference" of "independent action" (*i.e.*, an innocent state of mind). Similarly, the requirement of "*scienter*" would be read out of the securities laws if it would be permissible to infer *scienter* from the mere presence of facts that are equally consistent with innocent behavior.

Brown v. *Credit Suisse First Boston LLC*, 431 F.3d 36 (1st Cir. 2005), illustrates this point. In dismissing the complaint, the court of appeals explained that the fact that a stock analyst believed that a company's competitors had more robust growth than the company did not give rise to an inference that the analyst issued a "buy" recommendation against his personal belief, because the analyst might have rated the competitors as "strong buys" (based on their "strong" growth) when he gave the company a less aggressive, though still positive, "buy" rating (based on its "reasonable" growth). The court criticized the complaint for leaving "these and a myriad of other possibilities wide open," that is, for failing to allege sufficient additional facts that would make the fraud inference more likely. *Id.* at 51.

It also frequently occurs that the complaint pleads facts that negate, or undermine, any inference of *scienter* on behalf of a particular defendant. For example, a complaint alleging that the company concealed the fraud effectively negates *scienter* on the part of the auditor. *See, e.g.*, *In re Royal Ahold N.V. Sec. & ERISA Litig.*, 351 F. Supp. 2d 334, 390 (D. Md.

2004). The most convincing inference here is not that the accountants were in on the alleged scheme, but that they were tricked or misled by their client (and thus should be dismissed from the lawsuit). Refusing to consider the inference raised by the "concealment" allegation cannot be reconciled with the statutory directive to dismiss complaints that do not allege facts giving rise to a *strong* inference of *scienter.*

* * *

Both the absolute and the relative constraints on the pleading are implicit in the words used by Congress and are necessary to give effect to the statutory standard of "strong inference." A particular inference of *scienter* might be plausible, but unlikely; such an inference would not be "strong" in the absolute sense. Likewise, an inference could be likely, but no more likely than the alternatives; such an inference would not be "strong" in the relative sense. Thus, to satisfy the "strong inference" standard of the PSLRA, the particularized facts must give rise to an inference of *scienter* that is both (absolutely) likely and (relatively) more likely than competing non-culpable inferences.

II. The Policies Animating The PSLRA Require Meaningful Constraints On Scienter Pleading

The legislative history of the PSLRA shows that Congress sought to prevent and deter meritless "strike suits" that forced securities defendants to capitulate to avoid the massive costs of discovery and merits litigation. According to the Conference Committee, the PSLRA was intended to eliminate some of the abuses experienced in private securities litigation, such as "the routine filing of lawsuits . . . whenever there is a significant change in an issuer's stock price," the "abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle, and with only faint hope that the discovery process might lead eventually to some plausible cause of action," and the "manipulation by class action lawyers of the clients they

purportedly represent." *See* H.R. Conf. Rep. No. 369, *supra*, at 31.

The "strong inference" language in the PSLRA was drawn from a line of Second Circuit decisions that imposed a heightened pleading standard on securities-fraud plaintiffs. *See, e.g.*, S. Rep. No. 98, *supra*, at 15 ("[T]he Committee chose a uniform standard modeled upon the pleading standard of the Second Circuit. Regarded as the most stringent pleading standard, the Second Circuit requires that the plaintiff plead facts that give rise to a strong inference of defendant's fraudulent intent."); H.R. Conf. Rep. No. 369, *supra*, at 41 (the "Conference Committee language is based *in part* on the pleading standard of the Second Circuit," which was "[r]egarded as the most stringent pleading standard") (emphasis added). The legislative history thus shows that Congress sought to impose a standard that was at least as demanding as that applied in the Second Circuit. *See Nathenson* v. *Zonagen Inc.*, 267 F.3d 400, 412 (5th Cir. 2001); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 531-35 (3rd Cir. 1999). The Conference Committee pointedly stated, however, that "it d[id] not intend to codify the Second Circuit's case law interpreting this pleading standard." *Id.* at 532; *see also* H.R. Conf. Rep. No. 369, *supra*, at 41 n.23 ("For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness"). Accordingly, the Court should construe the "strong inference" standard—which is "no less" stringent than that of the Second Circuit—without the gloss that the Second Circuit has applied to that phrase.

Imposing an absolute threshold on securities plaintiffs will further the congressional objective by precluding suits in which intentional misconduct is not a forceful conclusion from available evidence. Similarly, imposing a relative check will preclude suits in which the plaintiffs' theory is placed into significant doubt by the available alternative explanations. The imposition of these requirements will not deter meritorious lawsuits, because cases in which adequate

information is alleged are mostly likely to present a "strong inference" of *scienter*. Of course, cases with insufficient, conclusory information will be precluded; but that, after all, was the purpose of the PSLRA.

Meaningful constraints are of particular importance in claims against peripheral actors such as auditors, who often are targeted when those more directly responsible for the alleged misconduct are unavailable or have become judgment-proof. Congress was concerned about the impact of vexatious litigation on secondary actors such as accounting firms when it passed the PSLRA. *See* S. Rep. No. 98, *supra*, at 9 ("Underwriters, lawyers, accountants, and other professionals are prime targets of abusive securities lawsuits. The deeper the pocket, the greater the likelihood that a *marginal* party will be named as a defendant in a securities class action") (emphasis added); *id.* at 21 (when "peripheral defendants are sued, the pressure to settle is overwhelming—regardless of the defendant's culpability").

Since this Court's rejection of secondary liability in *Central Bank*, accounting firms can no longer be sued for aiding and abetting securities fraud. But accounting firms are still sued, as they were in aiding and abetting cases, for peripheral conduct. In the decade since *Central Bank*, securities plaintiffs usually have sued accounting firms not for participating in a scheme to defraud with the audited company, but for their audit report—due to a failure to detect the accounting errors or fraud *committed by the audited company*. Although some plaintiffs have alleged that an audit report is misleading merely because it states that, in the auditor's opinion, the financial statements "fairly present" the financial position of the company, the auditors' alleged misstatement would not have happened absent an underlying error or fraud committed by the client in the first place. In that sense, the auditor's conduct remains secondary to the underlying fraud.

The main difference between the aiding-and-abetting suits filed before *Central Bank* and "primary" liability cases is the presence of an allegedly false or misleading sentence in

the auditor's report—*i.e.*, that, in the auditor's opinion, the company's financial statements have been presented in accordance with generally accepted accounting principles. But even an attestation that appears incorrect in hindsight does not prove that it was made with an "intent to deceive, manipulate, or defraud." *Hochfelder*, 425 U.S. at 185, 188. To the contrary, without more, failure to detect fraud by others usually involves at most negligent conduct, which does not violate the securities laws. *Ibid.* In the accounting context, moreover, errors in the company's financial statements do not in themselves establish that the auditors departed from the requisite standard of care in auditing those statements, much less that they did so with *scienter*. Due to the sampling nature of an audit and the necessity to rely on information received from the client, "even a properly planned and performed audit may not detect a material misstatement resulting from fraud." SAS 99 (§ 316.12) (AICPA 2002); *see also Bily* v. *Arthur Young & Co.*, 834 P.2d 745, 749 (Cal. 1992) ("For practical reasons of time and cost, an audit rarely, if ever, examines every accounting transaction in the records of a business. The planning and execution of an audit therefore require a high degree of professional skill and judgment."); *In re IKON Office Solutions, Inc.*, 277 F.3d 658, 673 (3d Cir. 2002) ("[E]ven an audit conducted in strict accordance with professional standards countenances some degree of calibration for tolerable error which, on occasion, may result in a failure to detect a material omission or misstatement").

The PSLRA was enacted, in part, to prevent the reflexive naming of accountants as defendants without regard to actual conduct. H.R. Conf. Rep. No. 369, *supra*, at 31 (noting that the PSLRA was meant to reduce abusive suits, particularly "the targeting of deep pocket defendants, including accountants . . . , without regard to their actual culpability"). But a decade after the PSLRA's enactment, the liability exposure of accounting firms "exceeds the combined partner capital of the Big Four firms." Interim Report of the Committee on Capital Markets Regulation 87 (2006) available at http://www.capmktsreg.org/pdfs/11.30Committee_Interim_R

eportREV2.pdf. "Any future lawsuits would only aggravate the exposure problem," because (*inter alia*) "[l]arge audit firms self-insure because third party insurance is unavailable." *Ibid.* The liability exposure also decreases the ability of accounting firms to retain and hire qualified talent, which could significantly reduce audit capacity for the thousands of companies requiring audit services. *Ibid.* "More fundamentally, such litigation could bankrupt another Big Four firm, with disastrous consequences for corporate governance worldwide." *Id.* at 86.

The audit process involves the application of judgment to complex, and potentially competing, accounting pronouncements. *See, e.g., Shalala* v. *Guernsey Mem'l Hosp.*, 514 U.S. 87, 100 (1995) ("Financial accounting is not a science. It addresses many questions as to which the answers are uncertain and is a 'process [that] involves continuous judgments and estimates.'") (alteration in original; citation omitted); *see also id.* at 101 ("There are 19 different GAAP sources, any number of which might present conflicting treatments of a particular accounting question"); *Bily*, 834 P.2d at 763 ("[The audit] report is the final product of a complex process involving discretion and judgment on the part of the auditor at every stage. Using different initial assumptions and approaches, different sampling techniques, and the wisdom of 20-20 hindsight, few CPA audits [are] immune from criticism."). To effectuate Congress's intent in enacting the PSLRA, a plaintiff suing an auditor must plead facts that, if proven, would convince a reasonable person both that the auditor departed from the wide zone of discretion afforded under applicable professional standards and that such departure was made with the requisite mental state.

Accordingly, because peripheral conduct is usually less likely to involve *scienter*, inferences relating to the *scienter* of peripheral actors must be particularly strong, and necessitate comparison of competing inferences. *See PR Diamonds*, 364 F.3d at 693. Absent particular facts from which a reasonable person should *strongly infer* intentional misconduct,

accounting firms and others should not face the crippling expense of defending against securities lawsuits.

III. Enforcing The Letter And Spirit Of The PSLRA Gives Rise To No Seventh Amendment Concerns

The Seventh Circuit expressed concern that giving full effect to the pleading requirements imposed by the PSLRA would somehow "usurp[] the jury's role." Pet. App. 13a. To the contrary, no Seventh Amendment issue arises from enforcing congressional constraints on pleading. Indeed, the *Matsushita* Court required consideration of competing inferences over a dissent that, among other things, advanced a similar Seventh Amendment objection. *See* 475 U.S. at 601 (White, J., dissenting).

"The jury was not absolute master of fact in 1791. Then as now courts excluded evidence for irrelevancy and relevant proof for other reasons"—that is, judges "weighed the evidence." *Galloway* v. *United States*, 319 U.S. 372, 390 (1943). Under this Court's Seventh Amendment jurisprudence, only "reasonable" inferences are for the jury. *Id.* at 395 ("the essential requirement is that mere speculation be not allowed to do duty for probative facts, after making due allowance for all *reasonably* possible inferences favoring the party whose case is attacked") (emphasis added). Indeed, it has long been understood that a case need not be submitted to the jury if the complaint is not supported by reasonable inferences. *Pawling v. United States*, 8 U.S. (4 Cranch) 219, 221-22 (1808) ("The party demurring admits the truth of the testimony to which he demurs and also those conclusions of fact which a jury may fairly draw from that testimony. Forced and violent inferences he does not admit"); *Western & Atl. R.R.* v. *Hughes*, 278 U.S. 496, 497-98 (1929) ("submission to the jury of contested issues of fact is not required in the federal courts, if there is only a scintilla of evidence").

Congress has authority to create or eliminate federal causes of action, and to define the elements of a federal cause of action. *Plaut* v. *Spendthrift Farm, Inc.*, 514 U.S. 211, 228-29 (1995). In doing so, Congress can require that only

claims that are well-pleaded at the time of filing may proceed in federal court. Fraud claims have always been subject to more exacting standards of pleading than other claims. *See* Fed. R. Civ. P. 9(b) ("the circumstances constituting fraud . . . shall be stated with particularity"). This Court has never suggested that there is any Seventh Amendment difficulty in rejecting a complaint that does not plead fraud with the required particularity. *See Swierkiewicz* v. *Sorema N.A.*, 534 U.S. 506, 513 (2002) (noting that Rule 9(b) imposes more rigorous pleading standards on certain claims); *Leatherman* v. *Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 168 (1993) (same). In the securities-fraud context, moreover, Congress was concerned about "the perceived inability of Rule 9(b) to prevent abusive, frivolous strike suits," and imposed an even higher pleading standard. *Nathenson*, 267 F.3d at 407; *see* S. Rep. No. 98, *supra*, at 4.

Congress may also alter "matters of form or procedure" without running afoul of the Seventh Amendment. *Baltimore & Carolina Line, Inc.* v. *Redman*, 295 U.S. 654, 657 (1935). In particular, it can set "standards and boundaries," including "evidentiary standards," based on which a judge must evaluate a case *before* that case is even submitted to a jury. *Anderson* v. *Liberty Lobby*, 477 U.S. 242, 252-55 (1986); *see also Galloway*, 319 U.S. at 390 (explaining that "higher standards of proof" do not implicate the Seventh Amendment because the Amendment does not "bind the federal courts to the exact procedural incidents or details of jury trial according to the common law in 1791").

The "strong inference" requirement of the PSLRA is precisely the type of evidentiary standard that may be imposed by Congress, which has made a cost-benefit determination, binding on the courts, that cases with pre-discovery information insufficient to indicate a strong likelihood that defendant acted intentionally cannot go forward into costly discovery—even if, had these cases gone into discovery, additional information could have been discovered that would have created at least a jury issue on whether the defendant

acted with *scienter*. Ignoring that congressional determination "would permit a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence." *Dura*, 544 U.S. at 347 (internal quotation omitted; alteration in original). By contrast, enforcing the congressional standard, which requires a plaintiff to plead particularized allegations giving rise to a "strong inference" of *scienter* as a precondition to allowing the case to proceed past the pleading stage, presents no constitutional difficulty.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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No. 06-484

IN THE
SUPREME COURT OF THE UNITED STATES

TELLABS, INC. AND RICHARD C. NOTEBART,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,
Respondents.

On Writ of Certiorari to
the United States Court of Appeals
For the Seventh Circuit

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INTEREST OF AMICI CURIAE*

The Center for Study of Responsive Law is a nonprofit, nonpartisan research and education organization. It was founded by Ralph Nader in 1968. Since then it has sponsored a wide variety of books, organizing projects, and litigation and has hosted hundreds of conferences focusing on corporate and government accountability. One of the Center's primary goals is to empower citizens. Public Citizen is a national, non-profit consumer advocacy organization that represents consumer interests before Congress, the executive branch, and the courts. One of its principal missions is ensuring the right of individual consumers to seek redress for their injuries in the courts. To that end, it has appeared before this Court numerous times as a party and as an *amicus curaie*.

SUMMARY OF ARGUMENT

Amici's principal contention is this: The heightened-pleading provision of the Private Securities Litigation Reform Act of 1995 (PSLRA), 15 U.S.C. § 78u-4(b)(2), does not require the plaintiff to plead facts establishing an inference any stronger than a jury would require to return a verdict for the plaintiff under the preponderance-of-the-evidence standard of proof. Facts that, if true, would allow a jury to conclude that the plaintiff's allegation of scienter is more likely true than not establish a "strong inference," and they do so even in the presence of so-called "competing inferences." Neither the PSLRA nor the Seventh Amendment allows a

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* No party's counsel wrote this brief (in whole or in part), and no person other than *amici* and their counsel contributed monetarily to this brief's preparation or submission. The parties' letters consenting to the filing of this brief have been lodged with the Clerk of the Court.

district court to demand that the plaintiff plead an inference any stronger than required to satisfy the burden of proof.

ARGUMENT

A. The Court Should Decline Petitioners' Invitation to Write Additional Gatekeeper Provisions Into the Carefully Constructed and Comprehensive Enforcement Provisions of the PSLRA.

1. The PSLRA was "the most ambitious overhaul of the private securities laws ever undertaken." Richard H. Walker & J. Gordon Seymour, *Recent Judicial and Legislative Developments Affecting Private Securities Fraud Class Actions*, 40 Ariz. L. Rev. 1003, 1023 (1998). This "comprehensive federal charter" was the product of years of Congressional investigation, consideration, and compromise. Geoffrey P. Miller, *Payment of Expenses in Securities Class Actions: Ethical Dilemmas, Class Counsel, and Congressional Intent*, 22 Rev. Litig. 557, 592 (2003).

Most of the PSLRA's reforms were targeted at the perceived abuse of securities class action litigation by the plaintiffs bar, not private securities fraud litigation as such. *See Merrill Lynch, Pierce, Fenner & Smith, Inc., v. Dabit*, 126 S. Ct. 1503, 1510 (2006). Congress did not seek to impede the access of defrauded investors to the federal courts or to immunize those who violate the law from liability for the financial loses they cause. To the contrary, Congress recognized that private litigation is "an essential supplement to criminal prosecution" and government enforcement actions, Brief of United States ("SG Br.") at 1, necessary both to ensure the integrity of the "capital markets" and to provide "defrauded investors" "an indispensable tool" to recover their financial losses. H.R. Conf. Rep. No. 104-369, at 1, *reprinted in* 1995 U.S.C.C.A.N. 730. *See Merrill Lynch*, 126 S. Ct. at 1510.

Over a decade after enactment of the PSLRA, Congress' commitment to private securities fraud litigation as an important vehicle to enforce the federal securities laws remains strong. This is reflected, among other things, in Congress' recent lengthening of the statute of limitations in private securities fraud cases. *See* 28 U.S.C. § 165.8(b).

2. The PSLRA made dozens of detailed changes to both the Securities Act of 1933, 48 Stat. 74, 15 U.S.C. § 77, and the Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C. § 78. The specific problem to which Congress directed the PSLRA's heightened pleading requirements was "the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to the underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plaintiff cause of action." H.R. Conf. Rep. No. 104-569 (statement of managers), *reprinted in* 1995 U.S.C.C.A.N. 730.

Yet the PSLRA's special pleading provision is but one of many provisions of the PSLRA's detailed and comprehensive enforcement scheme designed to protect securities issuers from these so-called "fraud by hindsight" suits. There are many others—most of them entirely ignored by Petitioners and the *amici* supporting them—including the statutory provisions that increase client control over the litigation by requiring (among other things) the plaintiff to certify that he or she has reviewed the complaint and authorized its filing, *see* 15 U.S.C. §§ 77z-1(a)(2)(A)(i), 78u-4(a)(2)(A(i); accord presumptive control of class litigation to a responsible lead plaintiff (which usually turns out to be an institutional investor) empowered to hire and fire lead counsel, *see id.* §§ 77z-1(a)(3)(B), 78u-4(a)(3)(b); impose a mandatory discovery stay unless and until the complaint survives a motion to dismiss, *see id.* §§ 77z-1(b)(1), 78u-4(b)(3)(B); augment

pleading requirements concerning the identity of the statements alleged to be fraudulent, *see id.* § 78u-4(b)(1); create a mandatory court review of parties' and attorneys' conduct under the sanction provisions of Fed. R. Civ. P. 11(b), and provide for a presumptive award of attorneys' fees as a sanction for Rule 11 violations, *see id.* §§ 77z-1(c), 78u-4; confer on the defendant a right to submit particularized written interrogatories to the jury on the issue of scienter, *see id.* §§ 77z-1(d), 78u-4(d); and immunize certain forward-looking statements from civil liability through a "safe harbor provision" (which itself contains special pleading requirements), *see id.* § 78.

Contrary to Petitioners' suggestion, the Court should not interpret the "strong inference" pleading requirement as if it were the PSLRA's exclusive protection against non-meritorious lawsuits. Rather, it should view that pleading requirement for what it is: but one of many links in a comprehensive network of detailed, interrelated, and mutually reinforcing defendant-protective provisions.

3. Although Petitioners and their *amici* ostensibly ask the Court only to interpret the PSLRA's "strong inference" pleading requirement, they are really asking the Court to authorize unprecedented incursions into well-established principles governing the disposition of motions to dismiss. Especially troubling is Petitioners' and the Solicitor General's contention that the Court should authorize district courts to (1) dismiss even complaints whose factual allegations, if true, would allow a jury to find scienter, *see infra* § B, (2) weigh and choose among competing inferences, *see infra* § C, and (3) displace the role of juries as fact-finders, *see infra* § D.

Petitioners ask the Court to impose procedural hurdles in securities litigation that Congress did not include in the PSLRA. Nowhere is this more evident than in Petitioners' request that the Court import into motion-to-dismiss practice

the summary judgment principles applied in two particular types of antitrust cases: predatory pricing conspiracy cases, *see Matsushita Elec. Industrial Co. v. Zenith Radio*, 475 U.S. 574 (1986), and vertical price fixing cases, *see Monsanto v. Spray-Rite Serv. Co.*, 465 U.S. 752 (1984). *See* Brief of Petitioner ("Pet. Br.") at 30-31. These are summary judgment cases decided under a statute that, unlike the PSLRA, delegates important policy-making functions to the courts. *See, e.g., State Oil Co. v. Khan*, 522 U.S. 3, 20 (1997). Petitioners offer no evidence that Congress intended to give courts similar policy-making authority under the PSLRA. That Petitioners are even relying on these cases shows just how far they have crossed the line between interpreting the PSLRA and prescribing a new set of procedural requirements to achieve their policy objectives.

4. Petitioners contend that, unless the Court imposes additional procedural hurdles on plaintiffs, too many non-meritorious suits will survive motions to dismiss. *See* Pet. Br. at 16; *see also* Brief of Chamber of Commerce et al. *passim*. All of the specific concerns that Petitioners identify, however, are already dealt with adequately in the PSLRA.

Petitioners contend, in particular, that the Court must address the problem of "strategic pleading"—the deliberate omission of facts that, had they appeared in the complaint, would have detracted from a cogent inference of scienter. *See* Pet. Br. at 17-18. But the PSLRA already addresses this claimed problem by requiring that, for each statement alleged to be "misleading," the complaint plead scienter "with particularity." U.S.C. § 78u-4(b)(2). Other provisions of the PSLRA likewise discourage strategic pleading, including the requirement that a lead plaintiff—which is usually an institutional investor—sign the complaint. *See id.* § 78u-4(a)(2)(A)(i). Few institutional investors will put their reputations on the line by signing misleading complaints.

B. The Plaintiff Need Not Plead Facts That, If True, Would Establish a Stronger Inference Than Required to Allow a Jury to Find Scienter Under the Governing Preponderance-of-the-Evidence Standard.

1. However the Court chooses to characterize the strength of the inference required by the PSLRA's pleading requirement, it should lay down one important constraint on trial courts deciding motions to dismiss under Fed. R. Civ. P. 12(b)(6): They may not, contrary to Petitioners', the Solicitor General's, and other *amici*'s overriding contention, demand a stronger inference of scienter than the underlying burden of proof applicable in securities fraud cases allows.

2. Although the PSLRA imposes heightened pleading requirements, it does not impose a heightened burden of proof at trial (or at summary judgment)—with respect to scienter or any other element of a private securities fraud cause of action. *See, e.g.*, *Phillips v. LCI Int'l*, 190 F.3d 609, 620 (4th Cir. 1999) ("The PSLRA did not change the standard of proof a plaintiff must meet or the kind of evidence a plaintiff must adduce to demonstrate scienter at trial in a securities fraud case."); *accord Florida. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 653-54 (8th Cir. 2001); *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 408 (5th Cir. 2001); *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1064 (9th Cir. 2000); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 200 (1st Cir. 1999); *In re Comshare Inc. Sec. Litig.*, 183 F.3d 542, 549-50 (6th Cir. 1999); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534 (3d Cir. 1999). The standard of proof remains preponderance of the evidence. *See, e.g.*, *SEC v. Ginsburg*, 362 F.3d 1292, 1298 (11th Cir. 2004). *See generally Herman & McClean v. Huddleston*, 459 U.S. 375, 390 (1983) (holding that preponderance-of-the-evidence standard applies to private securities fraud claims). To obtain a jury verdict and withstand a defense motion for judgment as a matter of law, then, the plaintiff need not introduce any more evidence than

a reasonable juror would need to conclude that the allegation of scienter is more likely true than not true. *See Herman*, 459 U.S. at 390 (holding that plaintiffs must prove "*that it is more likely than not* that they were defrauded") (emphasis added).

The Court should interpret the PSLRA's strong-inference pleading standard consistent with the plaintiff's burden of proof at trial. It should not require the plaintiff to plead facts that, if true, would establish an inference any stronger than necessary to allow a reasonable jury to return a verdict for the plaintiff under the preponderance-of-the-evidence standard—that is, for the jury to conclude that the plaintiff's allegation of scienter is more likely true than not. Requiring the plaintiff to plead an inference any stronger than the preponderance-of-the-evidence standard demands will result in the dismissal of complaints containing factual allegations strong enough (if proved) to support a jury verdict for the plaintiff. Congress could not have intended that anomalous—and, as we argue below, likely unconstitutional—result. *See infra* § D.

3. We are not urging the Court to adopt a standard that dilutes the "strong inference" requirement. An inference strong enough to allow the plaintiff to withstand a motion for judgment as a matter of law and sustain a jury verdict in the plaintiff's favor *is*, by any measure, a strong inference. Many legal inferences are not nearly so strong. One familiar sort of inference, for example, gives rise only to a prima facie case that serves to shift the burden of production (not persuasion) to the defendant; once met with contrary evidence, this inference loses its force. *See, e.g.*, *Swierkiewicz v. Sorema, N.A.*, 534 U.S. 506, 510-11 (2002) (discussing inference that gives rise to a prima facie case of discrimination under *McDonnell Douglas Corp. v. Green*, 411 U.S. 792 (1973), and progeny). We are only urging the Court to reject an interpretation of the PSLRA that puts its "strong inference" pleading standard at odds with the standard of proof.

4. The Solicitor General sees no need for any such constraint on the interpretation of the phrase "strong inference." He readily admits that the "practical effect" of the super-heightened pleading requirement he urges the Court to adopt would be to screen out complaints at the motion-to-dismiss stage whose factual allegations, if later proved, would suffice to allow a reasonable jury to find scienter under a preponderance-of-the-evidence standard. *See* SG Br. at 29-30 n.9. The Solicitor General suggests that this is the price of all heightened pleading requirements. *See id.* at 28-29. Not so. Heightened pleading and heightened proof requirements differ in important respects. *See, e.g., Ackerman v. Northwestern Mut. Life Ins. Co.*, 172 F.3d 467, 470 (7th Cir. 1999) (Posner, J.). Heightened pleading requirements demand that the plaintiff lay out, with greater specificity than Fed. R. Civ. P. 8's notice pleading requirements demand, the facts the plaintiff must later prove at trial to establish liability. But heightened pleading requirements generally do not dictate the required strength of the plaintiff's factual showing. That is a function of the underlying burden of proof.

C. The Court Should Interpret the "Strong Inference" Pleading Requirement to Give Effect to, Rather than Undercut, the Well-Established Division Between Judge and Jury Respecting Competing Inferences.

1. Of all the arguments made by Petitioners, none is as objectionable as their argument that the PSLRA authorizes district courts to weigh competing inferences at the motion-to-dismiss stage. Nothing in the PSLRA changes the time-honored principle that, in ruling on a pre-trial dispositive motion, a court must draw all reasonable inferences in favor of the non-moving party. The PSLRA's requirement that plaintiffs plead facts giving rise to a "strong inference" of the defendant's culpable mental state raises the initial bar plaintiffs must hurdle, but it in no way alters the fundamental principle of adjudication that "[t]he evidence of the

nonmovant is to be believed and *all justifiable inferences are to be drawn in his favor*." *Anderson v. Liberty Lobby*, 477 U.S. 242, 249 (1986) (emphasis added); *see City of Monroe Employees Retirement Sys. v. Bridgestone Corp.*, 399 F.3d 651, 683 (6th Cir. 2005) (so holding under the PSLRA).

Anderson is instructive because it involved a pretrial motion to dispose of a claim as to which the plaintiff confronted a heightened burden. To prevail on the merits of its defamation claim in *Anderson*, the plaintiff needed to offer "clear and convincing proof." 477 U.S. at 244. The Court clarified that insofar as the clear and convincing standard would govern the determinations at trial on the merits, it also applied on summary judgment. The Court then explained that the higher proof standard provided no license for a trial court to draw inferences and weigh evidence: "the weighing of the evidence, and the drawing of legitimate inferences from the facts are jury functions, not those of a judge." *Id.* at 249. Noted commentators have emphasized that *Anderson* precludes judges from "select[ing] from among disputed inferences." William W Schwarzer, Alan Hirsch, & David Barrans, *The Analysis and Decision of Summary Judgment Motions* 60 (Federal Judicial Conference 1991) (emphasis added) (hereafter "Schwarzer").

Anderson undercuts Petitioners' argument that the trial court should consider "innocent inferences" respecting scienter. A jury is free to consider such inferences. But the trial court is not. It must credit all of plaintiff's reasonable inferences. To do otherwise flies in the face of *Anderson*'s command that the facts be considered in the light most favorable to the plaintiff.

2. The controlling principle here is not some technical procedural rule; it lies at the heart of the judge-jury distinction and the right to a jury trial. "If there are any non-frivolous grounds for choosing between competing inferences, the jury should be permitted to choose. A court's judgment that two

inferences are equally strong is no substitute for a jury's." Schwarzer at 66. Under Petitioners' approach, a trial court would be licensed to make its own assessments of which inferences should be drawn, thereby usurping the fact-finder's role to choose between conflicting inferences. *See, e.g., Tennant v. Peoria & Pacific Union Ry.*, 321 U.S. 29, 35 (1944) ("It is not the function of a court to search the record for conflicting circumstantial evidence in order to take the case away from the jury on a theory that the proof gives equal support to inconsistent and uncertain inferences); *accord Schulz v Pennsylvania R.R. Co.*, 350 U.S. 523, 526 (1956).

3. *Anderson* involved summary judgment, but it has long been recognized that Fed. R. Civ. P. 12(b)(6), no less than Fed. R. Civ. P. 56 or Fed. R. Civ. P 50, requires that evidence be weighed and inferences drawn favorably to nonmovants even in cases involving heightened pleading requirements. *See, e.g., H.J. Inc. v. Northwestern Bell Tel. Co*, 492 U.S. 229, 249 (1989) (RICO); *SEC v. Zandford*, 535 U.S. 813, 818 (2002) (securities); *Illinois ex rel. Madigan v. Telemarketing Assocs.*, 538 U.S. 600, 618 (2003) (fraud). If anything, the court's role in deciding a motion to dismiss is more circumscribed than its role in deciding a summary judgment stage precisely because Fed. R. Civ. P. 12(b)(6) limits the court to the plaintiff's own allegations and requires the court to construe the allegations in the light most favorable to the plaintiff. *See, e.g., Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974).

4. This does not mean that plaintiffs cannot plead themselves out of court. As the Solicitor General notes, plaintiffs can include allegations that preclude a finding of scienter. *See* SG Br. at 25. What district courts may not do, however, is weigh the competing inferences that a jury could reasonably draw from the plaintiff's complaint allegations.

D. The Interpretation Urged by Petitioners, the Solicitor General, and Other *Amici* Puts the PSLRA on a Collision Course with the Seventh Amendment.

1. The Court has emphasized that the Seventh Amendment right to trial by jury is "fundamental" and should be "jealously" guarded and may not be abridged by Congress or the courts. *Parsons v. Bedford*, 28 U.S. (3 Pet.) 433, 446-48 (1830); *see also Slocum v. New York Life Ins. Co.*, 228 U.S. 364, 387 (1913). Even a "*seeming* curtailment of the right to a jury trial should be scrutinized with the utmost care." *Beacon Theatres, Inc. v. Westover*, 359 U.S. 500, 501 (1959) (emphasis added).

The construction of the PSLRA urged by Petitioners, if it does not render the PSLRA unconstitutional under the Seventh Amendment, at the very least raises serious questions as to the statute's constitutionality. Under the constitutional avoidance doctrine, the Court should choose an interpretation of the PSLRA that avoids a serious constitutional question where another—at least "permissible"—interpretation is before the Court. *Curtis* v. *Loether*, 415 U.S. 189, 192 n.6 (1974); *see also Feltner v. Columbia Pictures Television, Inc.*, 523 U.S. 340, 358-59 (1998) (J. Scalia, concurring) (emphasizing that the doctrine "does not require that the "problem avoiding construction" be the preferable one, just that it be a "reasonable one").

2. Petitioners and the Solicitor General urge the Court to interpret the heightened pleading requirement so as to authorize a district court to dismiss a complaint whose factual allegations, if true, would allow a jury to return a verdict for the plaintiff under the preponderance-of-the-evidence standard—and to do so by engaging in an inference-weighing exercise of the sort that *Anderson* forbids at the summary judgment stage even under a heightened standard of proof. Congress could not have intended, however, so serious an affront to the Seventh Amendment's right to a jury trial.

Congress can amend the securities laws to elevate the burden of proof at trial or require plaintiffs to plead particular facts or allegations with specificity. *See Dura Pharmaceuticals, Inc., v. Broudo*, 544 U.S. 336, 346 (2005). But we are aware of no cases holding that once Congress has established the burden of proof to determine the sufficiency of the evidence at trial, it may then condition the right to a jury trial on the pleading of factual allegations stronger than required to satisfy that burden. A case built around factual allegations that, if true, would permit a jury to return a verdict for the plaintiff cannot be screened out at the motion-to-dismiss stage or (assuming that the plaintiff backs his allegations with evidence satisfying Fed. R. Civ. P. 56) at the summary judgment stage either. It must go to the jury. *See Best v. District of Columbia*, 291 U.S. 411, 414 (1934).

It is no answer that Congress has created a number of procedural devices that "have diminished the civil jury's historic domain [but] have been found not to be inconsistent with the Seventh Amendment," *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 336 (1979), such as motions to dismiss, motions for summary judgment, and trial and post-trial motions for judgment as a matter of law. *See* Pet. Br. at 43 n.20; SG Br. at 28. The Court has repeatedly rejected efforts to use these devices to take an issue away from the jury when—construing the facts in a light most favorable to the plaintiff and drawing all reasonable inferences in the plaintiff's favor—a reasonable jury could return a verdict for the plaintiff. *See, e.g.*, *Tennant*, *supra*; *Shulz*, *supra*; *Best*, *supra*; *Swierkiewicz*, *supra*; *Conley v.* Gibson, 355 U.S. 41, 48 (1957); *see also* Eric Schnapper, *Judges Against Juries—Appellate Review of Federal Civil Jury Verdicts*, 1989 WIS. L. REV. 237, 241 (noting that from 1938 to 1968 the Court granted certiorari in 25 cases where appeals courts overturned jury verdicts for insufficient evidence and reinstated the jury verdicts in 24 cases).

3. The Solicitor General and several *amici* argue that because the strong inference pleading requirement is merely a pleading requirement, it presents a "threshold legal hurdle that a plaintiff must surmount in order to state a claim (and thereby obtain discovery)." SG Br. at 28. The right to a jury trial does not "accrue," they argue, until the plaintiff surmounts this threshold hurdle. *Id.* Hence Congress may condition the right to a jury trial on the plaintiff's satisfaction of any pleading requirement that Congress chooses to impose. No case supports this contention—especially not *Fidelity & Deposit Co. v United States*, 187 U.S. 315, 320 (1902), the principal case on which the Solicitor General relies. *Fidelty* upheld against a Seventh Amendment challenge a procedural rule that required a defendant in a contract action to set forth facts that, if true, would support his affirmative defense to the plaintiff's claim of breach. The rule authorized entry of judgment for the plaintiff when the defendant failed to submit an affidavit of defense after the plaintiff had filed his own supporting affidavit, just as Fed. R. Civ. P. 56 authorizes summary judgment for the plaintiff when the defendant faces a summary judgment motion and fails to marshal evidence sufficient to create a genuine issue of material fact. *See id.* ("The summary judgment procedure . . . 'prescribes the means of making an issue. The issue made as prescribed, the right of trial by jury accrues.' "). The rule did not demand that the defendant make a factual showing stronger than that required for the jury to return a verdict in his favor.

Fidelity does not suggest that pleading requirements never infringe upon Seventh Amendment rights. In fact *Fidelity* suggests otherwise. *Fidelity* quoted from *National Metropolitan Bank v. Hitz, I MacArth. & M. 198, 200* (S.Ct. D.C. 1879), to distinguish the rule at issue, which was not unconstitutional, from a rule that essentially required a party "try his case in his plea." *Id.* at 320 (quoting *Hitz*). In *Hitz*, the D.C. Supreme Court declared a court's entry of a verdict

for noncompliance with a rule that required one to try his case "in plea" would be improper because, in entering the verdict, the trial court would impermissibly resolves jury issues.

4. Contrary to the Solicitor General's position, application of pleading requirements may present Seventh Amendment questions. The "right . . . preserved [by the Seventh Amendment] *is the right to have the issues of fact presented by the pleadings* tried by a jury." *Slocum*, 228 U.S. at 397. A constitutional problem arises when the plaintiff pleads facts (at whatever level of specificity Congress may require) that would, if true, allow a reasonable jury to return a verdict for the plaintiff under whatever standard of proof governs the plaintiff's claim.

Assume, for example, that the PSLRA required the plaintiff to "*state with particularity sufficient facts giving rise to one and only one inference, namely, that the defendant acted with the required culpable state of mind*," but did not alter the burden of proof. Assume further that a plaintiff sufficiently alleged a "strong inference" of scienter and even attached a "smoking gun" document to the complaint that, if the jury credited, proved scienter. In this instance, the court's application of a pleading burden higher than the burden of proof at trial would result in the dismissal of the claim even though the jury could have—indeed likely would have—returned a verdict in favor of the plaintiff under the substantive law. A court's application of this heightened pleading requirement would render the right to a jury trial wholly illusory. Yet according to the Solicitor General's argument, the court's application of the heightened pleading standard under the above-referenced hypothetical would pose no Seventh Amendment problem because the plaintiff's right to a jury trial would never have "accrued."

The Solicitor General's contention proves too much. When a court dismisses a case whose factual allegations, if

true, would allow a jury to return a verdict for the plaintiff, the court has usurped the function of the jury to decide issues of fact and apply the law to the facts. The Seventh Amendment requires that juries determine whether the facts (alleged or evidenced) and the reasonable inferences drawn from them satisfy the plaintiff's burden of proof.

CONCLUSION

For the foregoing reasons, the Court should affirm the judgment of the Court of Appeals for the Seventh Circuit.

Respectfully submitted,

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IN THE

Supreme Court of the United States

TELLABS, INC., *ET AL.*,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *ET AL.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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INTEREST OF *AMICUS CURIAE*[1]

The Council of Institutional Investors ("Council") is a not-for-profit association of more than 130 public, labor, and corporate pension funds with assets exceeding $3 trillion. Its members are major long-term shareholders with duties to protect the retirement assets of millions of American workers. The Council is an advocate for strong corporate governance standards. Its members seek to protect plan assets through proxy votes, shareholder resolutions, pressure on regulators, discussions with management, and, when necessary, litigation. The Council has previously appeared as an *amicus* in cases affecting shareholder rights. *See, e.g., Devlin v. Scardelletti*, 536 U.S. 1 (2002); *CalPERS v. Felzen*, 525 U.S. 315 (1999).

The interests of the Council and its members are directly implicated by this case. In the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Congress recognized that institutional investors are uniquely positioned to represent the interests of absent class members and to prevent collusion between defendants and plaintiffs' attorneys in settling lawsuits. *See, e.g.*, H.R. Conf. Rep. No. 104-369, at 34 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 733 ("The Conference Committee believes that increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions."). Congress further recognized that institutional investors are America's largest shareholders and "'have the most to gain from meritorious securities litigation.'" *Id.* (quoting testimony of Maryellen Andersen, then treasurer of the Council). Institutional investors also have the most to lose from frivolous litigation that depletes share-

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[1] Pursuant to Supreme Court Rule 37.6, counsel for *amicus* represents that it authored this brief and that no person or entity other than *amicus* or its counsel made a monetary contribution to the preparation or submission of the brief. Counsel for *amicus* represents that counsel for all parties have filed letters with the Clerk reflecting their blanket consent to the filing of *amicus* briefs.

holder wealth. *See* S. Rep. No. 104-98, at 9 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 688 (quoting testimony of Maryellen Andersen that "'[w]e are . . . hurt if a system allows someone to force us to spend huge sums of money in legal costs by merely paying ten dollars and filing a meritless cookie cutter complaint against a company or its accountants'"). Accordingly, the Council has an interest in ensuring that judicial interpretation of the PSLRA is based on an accurate picture of the current state of securities class-action litigation. The Council believes that such interpretation should further Congress's goal of allowing legitimate suits to proceed while discouraging meritless "strike suits."

SUMMARY OF ARGUMENT

The Council does not take a position on how the Court should interpret the PSLRA's requirement that plaintiffs plead facts giving rise to a "strong inference" of scienter. Rather, the Council submits this brief to respond to the suggestion by petitioners and their *amici* that anything less than the strictest interpretation of that requirement will open the floodgates to frivolous securities litigation.

That suggestion lacks empirical support. *First*, despite the circuits' different glosses on the pleading standard, the PSLRA has generally succeeded in reducing frivolous litigation. It has increased the rate of dismissals as well as the proportion of meritorious suits, and it has substantially mitigated the agency costs, or divergence of interests between plaintiffs and their lawyers, with which Congress was concerned. *Second*, interpretive differences among the circuits have not led to forum shopping, undercutting the claim that anything less than the strictest reading of the pleading standard invites frivolous claims. Although the venue provisions of the securities laws permit national service of process, *see* Cert. Pet. 17, plaintiffs have not flocked to courts that endorse a broader interpretation of the scienter requirement. *Third*, the attack on the value of private securities litigation by petitioners and some of their *amici*, particularly the Chamber of

Commerce, is unwarranted. The private cause of action is an essential supplement to federal enforcement activity and has accordingly strengthened, not weakened, U.S. capital markets.

ARGUMENT

I. THE PSLRA HAS SUCCEEDED IN REDUCING FRIVOLOUS LITIGATION AND AGENCY COSTS

A. The PSLRA Has Reduced Frivolous Litigation

In enacting the PSLRA, Congress aimed to reduce the settlement value of meritless lawsuits by permitting dismissal before costly discovery. *See* H.R. Conf. Rep. No. 104-369, at 37, 1995 U.S.C.C.A.N. at 736; S. Rep. No. 104-98, at 14, 1995 U.S.C.C.A.N at 693. The statute has served that purpose. The pre-trial dismissal rate for securities class actions has nearly doubled since enactment of the PSLRA. Between 1991 and 1995, dismissals accounted for approximately 19% of dispositions; between 2000 and 2004, they accounted for approximately 38%. *See* Todd Foster *et al.*, NERA Economic Consulting, *Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar* 4 (Jan. 2007), *available at* http://www.nera.com/image/BRO_Recent_Trends_SEC1288_FINAL_0307.pdf ("*Recent Trends January 2007*"). Both the Second and Ninth Circuits – courts with divergent interpretations of the pleading standard – dismiss approximately 20% of cases within two years of the filing date. *See id.*

While there is no consistent post-PSLRA trend in the total number of securities class-action filings, that number dropped significantly in 2005 and 2006. Filings plunged to a record low in 2006 after a sharp decline in the second half of 2005. *See* Cornerstone Research, *Securities Class Action Case Filings, 2006: A Year in Review* 1 (2007), *available at* http://www.cornerstone.com/securities/pdfs/YIR2006.pdf ("*2006 Year in Review*"); *Recent Trends January 2007*, at 1; PricewaterhouseCoopers, *2005 Securities Litigation Study* 3 (2006), *avail-*

able at http://www.pwc.com/images/us/eng/about/svcs/advisory/pi/SecLitStudy_2005_Final.pdf ("*2005 Securities Litigation Study*"). Professor James Cox has testified that this drop "reflects the confluence of several on-going forces that are likely to stabilize or cause further reduction in the number of new filings," including Sarbanes-Oxley reforms and the petering out of filings relating to the financial and accounting fraud that came to light in 2001 and 2002. *Investor Protection: A Review of Plaintiffs' Attorney Abuses in Securities Litigation and Legislative Remedies, Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 109th Cong. 63-64 (2006), *available at* http://financialservices.house.gov/media/pdf/109-102.pdf ("*Investor Protection Hearing*") (prepared statement of James D. Cox). By contrast, the occasional spikes in filings in the post-PSLRA period do not reflect any general trend. For example, plaintiffs filed a large number of suits in 2001 in the wake of "laddering" allegations regarding initial public offerings ("IPOs"); shortly thereafter, within another discrete time period, plaintiffs filed a large group of suits related to analyst conflicts, mutual fund late trading, and market timing. *See* Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 Colum. L. Rev. 1489, 1497 (2006).

Since the PSLRA, both mean and median settlement amounts have increased. *See Recent Trends January 2007*, at 5 (median settlement amounts continued to rise in 2006); News Release, Cornerstone Research, *Securities Class Action Settlements Reach Record Level in 2005, Median Settlement Size Nearly 20% Above 2004 Levels* at 1 (Feb. 7, 2006), *available at* http://securities.stanford.edu/settlements/REVIEW_1995-2005/settlements_Through_12_2005_PR.pdf (median settlement size for all post-PSLRA years increased 19% in 2005, the largest single-year increase); *2005 Securities Litigation Study* at 16 (average settlement amount was dramatically higher in 2005).

Studies show that the higher settlements post-PSLRA reflect a higher proportion of meritorious litigation. For example, Professors Marilyn Johnson, Karen Nelson, and A.C. Pritchard found that the PSLRA led to "more precise targeting of securities class actions against firms likely to have committed fraud." Marilyn F. Johnson *et al.*, *Do The Merits Matter More? The Impact of the Private Securities Litigation Reform Act* 28-29 (Univ. of Mich., John M. Olin Center for Law & Economics, Working Paper No. 02-011, 2006), *available at* http://ssrn.com/abstract=883684; *see also id.* at 28 (concluding that post-PSLRA litigation is more closely correlated to restatements and abnormal insider stock sales, and less likely to be triggered by voluntary earnings warnings); Stephen Labaton, *Businesses Seek Protection on Legal Front*, N.Y. Times, Oct. 29, 2006, § 1, at 1 (quoting Professor Cox, who studied 600 class actions over the previous decade and found few "abusive or malicious" suits). As Professor Cox explained to Congress:

> The high and apparently rising dismissal rate is not consistent with the thesis that baseless suits mature into extortionate settlements. Instead, the declining rates of filings support the view that doctrinal and legislative developments reviewed above are having a most sobering impact on decisions to prosecute securities class action settlements.

Investor Protection Hearing at 66 (prepared statement of James D. Cox). The PSLRA has also resulted in fewer quick settlements, further indicating a shift away from frivolous suits that defendants settle speedily and for small amounts to avoid the expense of defense. *See* Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 Vand. L. Rev. 1465, 1496-98 (2004).

Indeed, the PSLRA may have reduced the number of meritorious class actions as well as frivolous actions. The statute's potential overinclusiveness counsels against an assumption that the strictest interpretation of the pleading standard best serves Congress's policy goals. Professor Stephen Choi has found that a significant number of

non-nuisance suits lacking pre-filing hard evidence, as well as non-nuisance suits involving smaller frauds, would not be brought after the PSLRA. *See* Stephen Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J.L. Econ. & Org. (forthcoming 2007) (working paper at 24, Am. Law & Econ. Ass'n, Am. Law & Econ. Ass'n 15th Annual Meeting, Working Paper 25, 2005), *available at* http://law.bepress.com/alea/15th/art25; Choi, 57 Vand. L. Rev. at 1473, 1523. Others have similarly cautioned that the PSLRA may screen out meritorious claims. *See, e.g.*, Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 Ariz. L. Rev. 711, 714-15 (1996) (PSLRA is insufficiently attentive to the economic costs of "false negatives," or elimination of legitimate fraud claims, as opposed to "false positives"); Eric L. Talley & Gudrum Johnsen, *Corporate Governance, Executive Compensation, and Securities Litigation* 25 (Univ. of S. Cal. Law Sch., Olin Research Paper No. 04-07, 2004), *available at* http://ssrn.com/abstract=536963 (PSLRA has discouraged meritorious litigation in addition to frivolous litigation); *Investor Protection Hearing* at 116 (letter submitted for record from Barbara Roper, Director of Investor Protection, Consumer Federation of America) ("[T]he research we have seen suggests that PSLRA both reduced the number and changed the nature of securities class action lawsuits filed in its wake. Some have even concluded that its provisions did more than screen out frivolous cases, but also prevented certain types of meritorious cases from being brought.").

In sum, the empirical evidence does not indicate that a tougher pleading standard is necessary to the PSLRA's goal of reducing frivolous filings. In fact, the evidence suggests that adoption of the strictest possible standard may tilt the balance struck by the PSLRA too far in the direction of eliminating meritorious suits. *Cf. The Common Sense Legal Reforms Act of 1995, Hearing on H.R. 10 Before the Subcomm. on Telecommunications and Finance of the H. Commerce Comm.*, 104th Cong. 1 (1995) (pre-

pared testimony of Arthur Levitt, SEC Chairman), *available at* http://www.sec.gov/news/testimony/testarchive/1995/spch025.txt ("Although we might strive for a system in which corporate issuers never spend a dime defending meritless claims, we should recognize that it is impossible to eliminate all meritless cases without also affecting the cases that do have merit and thereby eroding the deterrence provided by private actions.").[2]

B. The PSLRA Has Reduced Agency Costs

Nor is endorsement of the strictest pleading standard necessary to accomplish another principal goal of the PSLRA: the reduction of agency costs resulting from the divergence of interests between plaintiffs, who might hold

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[2] Petitioners and their *amici* may also overestimate the proportion of frivolous "strike suits" before the PSLRA. Both petitioners (at 28) and the Chamber of Commerce (at 8) cite a pre-PSLRA article by Professor Janet Alexander arguing that securities lawsuits regularly, and regardless of their merits, settled for 25% of the amount at stake – spurring plaintiffs to file frivolous suits. *See* Janet Cooper Alexander, *Do The Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497 (1991). Congress relied on that study as well. *See* S. Rep. No. 104-98, at 8 & n.19, 1995 U.S.C.C.A.N. at 687. Professor Alexander's analysis, however, was based on a sample of only eight settlements, *see* 43 Stan. L. Rev. at 516-18, and has been widely criticized. *See, e.g.*, James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 Ariz. L. Rev. 497, 503-04 (1997) (Alexander's study ignored mitigation in calculating damages at stake; taking mitigation into account, settlements ranged from 23% to 79% of recoverable damages, hardly proof that the "merits don't matter"); Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2080-81 (1995) (other studies have found significant correlations between recoveries and merits); Joel Seligman, *The Merits Do Matter*, 108 Harv. L. Rev. 438, 453 (1994); Leonard B. Simon & William S. Dato, *Legislating on a False Foundation: The Erroneous Academic Underpinnings of the Private Securities Litigation Reform Act of 1995*, 33 San Diego L. Rev. 959, 964 (1996); *see also* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1536 n.5 (2006) ("The true 'strike suit' nuisance action, filed only because it was too expensive to defend, is, in the author's judgment, a beast like the unicorn, more discussed than directly observed.").

only a nominal number of shares in the defendant company, and their lawyers. Congress enacted the PSLRA in large part to address "the manipulation by class action lawyers of the clients whom they purportedly represent." H.R. Conf. Rep. No. 104-369, at 32, 1995 U.S.C.C.A.N. at 731. Congress was concerned about lawyers inducing "professional plaintiffs" to file suits that extract attorneys' fees at the expense of investors, who either receive inadequate compensation for wrongdoing or bear the costs of settling a meritless case. *See id.* at 32-33, 1995 U.S.C.C.A.N. at 731-32; S. Rep. No. 104-98, at 6, 1995 U.S.C.C.A.N. at 685. Congress aimed to stop such "lawyer-driven lawsuits" by "giving control of the litigation to lead plaintiffs with substantial holdings." H.R. Conf. Rep. No. 104-369, at 32, 1995 U.S.C.C.A.N. at 731. *See generally* Weiss & Beckerman, 104 Yale L.J. 2053; S. Rep. No. 104-98, at 11 & n.32, 1995 U.S.C.C.A.N. at 690 (explaining that the Weiss and Beckerman article "provided the basis for the 'most adequate plaintiff' provision"). Accordingly, the PSLRA's procedures for the appointment of lead plaintiffs and lead counsel sought to "increase the likelihood that institutional investors will serve as lead plaintiffs." H.R. Conf. Rep. No. 104-369, at 33, 1995 U.S.C.C.A.N. at 732; *see* S. Rep. No. 104-98, at 11, 1995 U.S.C.C.A.N. at 690 ("The Committee believes that an institutional investor acting as a lead plaintiff can, consistent with its fiduciary obligations, balance the interests of the class with the long-term interests of the company and its public investors."). The PSLRA has achieved that aim.

The percentage of securities class actions with an institutional lead plaintiff has grown significantly since the enactment of the PSLRA, and particularly since 2000. In 1996, unions and pension funds were lead plaintiffs in approximately 3% of cases filed. By 2002, that figure had grown to approximately 27% and, by 2005, to approximately 41%. *See 2005 Securities Litigation Study* at 7, 21; PricewaterhouseCoopers, *2003 Securities Litigation Study* 6 (2004), *available at* http://www.10b5.com/2003_study.

pdf; *see also* Ronald I. Miller *et al.*, NERA Economic Consulting, *Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, Is Stabilization Ahead?* 8 (Apr. 2006), *available at* http://www.nera.com/image/BRG_RecentTrends2006_SEC979_PPB-FINAL.pdf ("*Recent Trends April 2006*") (in 2000, 14% of settled cases had an institutional lead plaintiff, while in 2005 38% did); Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2003*, at 9 (2004), *available at* http://securities.cornerstone.com/pdfs/2003_settlements.pdf (through 2003, approximately 30% of post-PSLRA settlements involved institutions as lead plaintiffs). Several studies have shown that, controlling for other variables, cases with institutional investors as lead plaintiffs result in higher recoveries for shareholders. *See* Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Post-Reform Act Securities Settlements: 2005 Review and Analysis* 9 (2006), *available at* http://securities.cornerstone.com/pdfs/settlements_2005.pdf ("*2005 Review and Analysis*") (controlling for case size as well as other factors, an institutional investor as lead plaintiff is associated with a statistically significant increase in settlement size); *Recent Trends April 2006*, at 8 (controlling for other case characteristics, suits with institutional lead plaintiffs settled for a statistically significant one-third more); James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 Colum. L. Rev. 1587, 1592 (2006) (finding higher settlements in institutional investor-led cases controlling for estimated provable losses, firm market capitalization, presence of a Securities and Exchange Commission ("SEC") enforcement action, and length of class period).

In addition to evidence that institutional investors negotiate better settlements, there is substantial evidence that they effectively monitor class counsel and negotiate more favorable fee arrangements. A study by Professor Michael Perino found that cases with public pension fund

lead plaintiffs settle for greater amounts, involve greater attorney effort, and produce lower fee requests and awards. *See* Michael A. Perino, *Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions* 1, 31-32 (St. John's Univ. Sch. of Law, Legal Studies Research Paper Series, Paper No. 06-0055, 2006), *available at* http://ssrn.com/abstract=938722; *see also* Michael A. Perino, *Markets and Monitors: The Impact of Competition and Experience on Attorneys' Fees in Securities Class Actions* 3, 26-27, 30 (St. John's Univ. Sch. of Law, Legal Studies Research Paper Series, Paper No. 06-0034, 2006), *available at* http://ssrn.com/abstract=970577 (concluding that the presence of repeat institutional players and in some circumstances of institutional objectors lowers fee awards; noting that public pension funds "have incentives to design and develop innovative compensation arrangements that will enhance the deterrence and compensation goals that provide the underlying premise for private enforcement"); Jill E. Fisch, *Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction*, 102 Colum. L. Rev. 650, 703-14 (2002) (finding negotiation by institutional lead plaintiffs superior to auctions as a method of selecting class counsel); James D. Cox & Randall S. Thomas, *Empirically Reassessing The Lead Plaintiff Provision: Is The Experiment Paying Off?* 16 (Vanderbilt Univ. Law Sch., Working Paper No. 05-21, 2005), *available at* http://ssrn.com/abstract=783948 (observing that, in the Cendant litigation, the institutional lead plaintiff negotiated a fee approximately $76 million less than the lowest bid submitted in the trial court's auction, a result that "reflects the broader experience of institutional investors who have found that they are able to lower the fees paid to class counsel . . . by one-half to one-third").

Active participation by public and labor pension funds is particularly crucial because, unlike other institutional investors such as banks and mutual funds, they are unlikely to have commercial interests that would be jeop-

ardized by suing management. *See* Cox & Thomas, 106 Colum. L. Rev. at 1609-10 (banks, insurance companies, and mutual funds may be "unwilling to lead the assault on executives who have issued misleading reports if such visibility could pose problems in selling financial services to other executives"; "[c]onsorting with 'class action lawyers' does not win one friends at the executive suites of America or at the club").

Finally, institutional investors are motivated to seek corporate governance reforms as well as accountability from executives, promoting the goal of deterrence. *See, e.g., Securities Lawsuits: Classier Actions*, The Economist, Feb. 17, 2007, at 76-77 (summarizing evidence that institutional investors keep a "tight leash" on their lawyers, are "better at squeezing lawyers' fees and their share of settlements," and "increasingly insist that companies reform their governance"); *2005 Review and Analysis* at 10 (noting that, in the WorldCom litigation, the institutional lead plaintiff insisted on personal contributions from outside directors); *cf.* Coffee, 106 Colum. L. Rev. at 1538 (arguing that, for securities class actions to fulfill their deterrent purpose, damages should fall more heavily on corporate insiders); Stephen J. Choi *et al., Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 Wash. U. L.Q. 869, 901 n.91 (2005) (public pension fund involvement may make private litigation function more like public enforcement, which values deterrence and accountability in addition to compensation).

Because of the PSLRA, the lead plaintiffs in a large and growing proportion of securities class actions are institutions motivated to pursue the interests of the plaintiff class as well as the long-term interests of the defendant company and its public investors. *See* S. Rep. No. 104-98, at 11, 1995 U.S.C.C.A.N at 690. Scholars have suggested additional steps that would encourage an even greater number of institutions to step forward as lead plaintiffs, further eliminating the disjunction of interests between plaintiffs and lawyers that can produce meritless litiga-

tion. *See, e.g.*, Cox & Thomas, 106 Colum. L. Rev. at 1587 (proposing measures such as compensating institutional plaintiffs for a multiple of their actual costs); Perino, *Markets and Monitors* at 30-31 (proposing additional incentives for public pension fund involvement). Thus, experience under the PSLRA to date demonstrates that adoption of the most stringent pleading standard is not necessary to achieve the statute's aims. Indeed, continuing promotion of institutional-investor involvement may be the best way to achieve those aims without screening out meritorious suits. *Cf.* Stout, 38 Ariz. L. Rev. at 715 (focusing on changing the choice of lead plaintiff, instead of making it harder for plaintiffs to bring fraud claims, might do much to address "false positive" error without unduly increasing the risk of "false negative" error).

II. DIFFERENCES IN PLEADING STANDARDS HAVE NOT RESULTED IN FORUM SHOPPING

The failure of interpretive differences among the circuits to result in forum shopping confirms that a less stringent reading of the "strong inference" standard is not an invitation to frivolous suits. The Second and Ninth Circuits have historically played host to the largest numbers of securities class actions, not because of any peculiarities of legal interpretation, but because of the business centers they encompass. *See, e.g., 2005 Review and Analysis* at 17 (court circuits are not significant in explaining settlement size; case jurisdiction is correlated with factors such as the concentration of technology firms in the Ninth Circuit); *Recent Trends April 2006*, at 2 ("many Ninth Circuit filings are against issuers in high-tech industries").

Amicus Technet attempts to suggest a correlation between "suit frequency and pleading standard laxity," claiming that the Second Circuit had more filings than the Ninth Circuit in 2005 and 2006 because it adopted a laxer pleading standard. Technet *et al.* Br. 8 n.3. That correlation does not exist. According to petitioners and their *amici*, the Ninth Circuit endorsed a stringent read-

ing of the PSLRA pleading standard in 1999 and again in 2002. *See In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 977 (9th Cir. 1999) (requiring "deliberate recklessness," defined as "a form of intentional conduct," for scienter) (cited by the United States at 11 n.2); *Gompper v. VISX, Inc.*, 298 F.3d 893, 897 (9th Cir. 2002) ("strong inference" of scienter does not exist if innocent inference "is equally if not more plausible" than culpable inference). Yet the Ninth Circuit had the most filings of any circuit in 2000 and 2004. *See Recent Trends January 2007*, at 4; *Recent Trends April 2006*, at 3; Elaine Buckberg *et al.*, NERA Economic Consulting, *Recent Trends in Securities Class Action Litigation: 2003 Early Update* 3 (Feb. 3, 2004), *available at* http://www.nera.com/image/NERA_Recent _Trends_2003_Early_Update.pdf.

Technet also cites a study by Professor Perino, which focused on the Ninth Circuit's adoption of the "deliberate recklessness" test in *Silicon Graphics* – not on the court's interpretation of "strong inference." Perino examined data through 2000 and found a trend away from Ninth Circuit litigation. *See* Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. Ill. L. Rev. 913, 944 (2003). He conceded, however, that the decline in Ninth Circuit filings began before the *Silicon Graphics* decision, and that the circuits adopting the least stringent requirements for scienter had not seen any significant increases in class-action filings. *See id.* at 945-46. Moreover, *Silicon Graphics* was decided in July 1999, and Perino looked only at 1999 and 2000 filings to determine the decision's effect. In 2004, a higher percentage of cases was filed in the Ninth Circuit than pre-*Silicon Graphics*. The same was true in 2001, excluding the discrete group of cases relating to "laddering" in IPO allocation, *see supra* p. 4. *See* PricewaterhouseCoopers, *2001 Securities Litigation Study* 5 (2002), *available at* http://www.10b5.com/2001SecuritiesLitigationStudy.pdf ("*2001 Securities Litigation Study*") ("Aside from the laddering cases, the Ninth Circuit continues to lead the nation in shareholder

class actions.").[3] The Ninth Circuit did have fewer filings in 2002 and 2003, but that likely resulted from the decline of the Nasdaq stock market, where many Internet-related companies traded. *See 2006 Year in Review* at 15. Similarly, the smaller number of Ninth Circuit filings in 2005 reflected a drop in filings associated with technology and Internet-related issuers. *See id.* In 2006, Ninth Circuit filings declined in comparable proportion to all filings. By contrast, the Seventh and Tenth Circuits – which apply a less strict pleading standard – experienced disproportionate slowdowns. *See id.*

Thus, despite the availability of nationwide service of process and resulting opportunity for forum shopping, *see* Cert. Pet. 17, there is no empirical support for the proposition that suits have migrated to circuits with less strict pleading standards. On the contrary, the fluctuations in Ninth Circuit filings appear to correlate with fluctuations in the number of suits against technology companies, suggesting that plaintiffs are – quite naturally – likely to sue companies where they are based. The courts that endorse a broader interpretation of the "strong inference" requirement have not experienced a flood of frivolous securities litigation. Accordingly, there is no reason to believe that this Court's adoption of such an interpretation would cause the parade of horribles predicted by petitioners and their *amici*.

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[3] The IPO allocation cases were overwhelmingly filed in the Second Circuit against defendants located in New York. They alleged violations of Sections 11 and 12 of the Securities Act of 1933, 15 U.S.C. §§ 77k, 77*l*, which arguably were not subject to the heightened pleading standard, as well as violations of SEC Rule 10b-5, 17 C.F.R. § 240.10b-5. *See* Perino, 2003 U. Ill. L. Rev. at 942-43 & n.162. Counting the IPO allocation cases, approximately 70% of 2001 filings were in the Second Circuit – far higher than in any previous or subsequent year. Not counting those cases, approximately 32% of filings were in the Ninth Circuit, compared to approximately 18% in the Second Circuit – close to the 20% of filings in the Second Circuit in the previous year, 2000. *See 2001 Securities Litigation Study* at 5.

III. PRIVATE SECURITIES LITIGATION IS AN ESSENTIAL SUPPLEMENT TO PUBLIC ENFORCEMENT

Petitioners and some of their *amici* suggest that public enforcement of the securities laws renders private litigation of minimal benefit, and that the Court should therefore adopt a strict pleading standard on policy grounds. *See* Pet'rs Br. 29 (citing the Chamber of Commerce's brief for the proposition that the SEC is willing and able to enforce securities laws); Chamber *et al.* Br. 17-19. But Congress, this Court, and the SEC have all reached an opposite conclusion. In enacting the PSLRA, Congress recognized that private securities litigation is "an indispensable tool with which defrauded investors can recover their losses" and is crucial "to the integrity of American capital markets." H.R. Conf. Rep. No. 104-369, at 31, 1995 U.S.C.C.A.N. at 730. Similarly, the Court has emphasized that "implied private actions provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to [SEC] action.'" *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)).

The SEC has consistently stressed the importance of private litigation as a supplement to its limited enforcement resources. *See, e.g., The Securities Litigation Uniform Standards Act of 1997, Hearing on S. 1260 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. 5-6 (1997) (prepared testimony of Arthur Levitt, SEC Chairman, and Isaac C. Hunt, SEC Commissioner), *available at* http://www.sec.gov/testimony/testarchive/1997/tsty1997.txt ("Private actions are an especially important supplement to the Commission's enforcement program today because of the phenomenal growth of the securities industry during a time when the Commission's staff and budget levels have remained relatively constant."); *Private Litigation Under the Federal Securities Laws, Hearings Before the Subcomm. on Securities of the*

S. Comm. on Banking, Housing, and Urban Affairs, 103d Cong. 113-14 (1993) (testimony of William R. McLucas, Director, SEC Division of Enforcement) (SEC enforcement actions cannot substitute for private actions because, "[a]lthough the Commission usually makes disgorged funds available for the compensation of injured investors, the amount of investor losses often exceeds the wrongdoer's ill-gotten gains"); *Securities Investor Protection Act of 1991, Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 102d Cong. 15-16 (1991) (testimony of Richard C. Breeden, SEC Chairman) (SEC is able to prosecute only a fraction of the cases in which investors have suffered losses); U.S. Br. 1.

As then-Chairman Levitt explained, funding for public enforcement has not kept pace with growth in the securities market. *See* Joel Seligman, *The Transformation of Wall Street: A History of the SEC and Modern Corporate Finance* 630 (3d ed. 2003) (during most of the 1990s, the SEC's budget grew at 6% per year, while virtually every significant measure of securities activity grew far faster). Even in major scandals where the SEC brings an enforcement proceeding, private settlements are typically many times the damages paid to the SEC. *See 2005 Review and Analysis* at 13 fig. 12. For example, in the WorldCom litigation, the SEC obtained $750 million for investors, while the related class action obtained $6.2 billion; in the Lucent Technologies litigation, the SEC obtained $25 million, while the class action obtained $517 million. *See id.* In other cases where the SEC failed to recover any significant amount for defrauded investors, private suits recovered substantial sums – for example, $3.2 billion in the Cendant litigation, *see In re Cendant Corp. Litig.*, 264 F.3d 201, 217 (3d Cir. 2001), and $444 million to date in the Global Crossing litigation, *see* Scott Moritz, *Global Crossing Settlement*, TheStreet.com, July 26, 2006, *available at* http://www.thestreet.com/_tscs/newsanalysis/techtelecom/10299504.html.

Petitioners and some of their *amici* also suggest that private securities litigation has caused the flight of capital

from the United States. They rely on a report by the Committee on Capital Markets Regulation – a group composed predominantly of corporate and financial executives, *see Interim Report of the Committee on Capital Markets Regulation* 4 (Nov. 30, 2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf – as well as a McKinsey report commissioned by Mayor Bloomberg and Senator Schumer. *See* Pet'rs Br. 29 n.14; New England Legal Foundation Br. 17; Chamber *et al.* Br. 9-12. Both reports blame the stricter U.S. legal framework – including the Sarbanes-Oxley reforms and private securities litigation – for a decline in initial public offerings on U.S. exchanges. *See* Jim O'Neill *et al.*, Goldman Sachs Economic Research Group, *Is Wall Street Doomed?*, Global Economics Weekly 1-2 (Feb. 14, 2007) (summarizing the recent reports); Chamber *et al.* Br. 11-12.

This Court, however, should not base its interpretation of the PSLRA on the proposition that private securities litigation has caused a drop in U.S. listings. That proposition is highly dubious. A recent Goldman Sachs study concluded that economic and geographic factors, rather than the legal environment, were primarily responsible for the shift in global capital markets activity. *See Is Wall Street Doomed?* at 1-6 (explaining that the U.S. has been losing market share for decades and that growth of capital markets outside the U.S. is a "natural consequence of economic growth and market maturation elsewhere"). Similarly, an Ernst & Young report concluded that the relative decline in U.S. IPOs is largely due to accelerating growth throughout the global economy, the increased ability of various capital markets to support IPOs, and a long-standing trend for companies to go public in their home countries. *See* Ernst & Young, *Global Capital Market Trends* 1-4 (Jan. 2007). Ernst & Young also found that the U.S. is very successful in attracting those companies that choose not to list locally and put themselves "in play" among capital market competitors. *See id.* at 2-3. That success is especially impressive because commissions and

fees to take a company public are higher in the U.S. than in other countries. *See* Hsuan-Chi Chen & Jay R. Ritter, *The Seven Percent Solution*, 55 J. Fin. 1105, 1112-13 (2000). Other analysts have suggested that U.S. IPO activity is currently robust and have questioned the quality of foreign IPOs. *See* Jack Willoughby, *IPOs Catch Fire*, Barrons, Jan. 29, 2007, at 21 (reporting that U.S. IPO volume in 2006 was 22% greater than in 2005, and a record number of those companies were profitable); David Henry, *London's Freewheeling Exchange*, BusinessWeek, Nov. 27, 2006, at 40 (describing evidence that London's lax standards attract companies that could not go public in the U.S.; noting that, according to a Dealogic study, IPOs greater than $100 million were up 20% on the New York Stock Exchange in 2006, compared to only 11% on the London Stock Exchange).

Finally, studies have found that foreign firms cross-listed on U.S. exchanges have lower costs of capital and increased valuations, demonstrating that investors rate companies more highly when they subject themselves to U.S. laws and regulations. *See, e.g.*, NYSE Group, Inc., *Foreign Firms Cross-Listed in U.S. Valued Higher*, The Exchange, Vol. 12, No. 10 (Oct. 2005), *available at* http://www.nyse.com/about/publication/1131450075226.html; Charles D. Niemeier, Public Company Accounting Oversight Board, *American Competitiveness in International Capital Markets* (Sept. 30, 2006), *available at* http://www.pcaobus.org/News_and_Events/Events/2006/Speech/09-30_Niemeier.aspx (reviewing data and concluding that "claims that the cost of securities regulation in the United States . . . has damaged the competitiveness of U.S. companies and markets are to my mind overstated," and that "the U.S. financial reporting and disclosure system has strengthened U.S. markets' resilience for the long-term and contributes significantly to the competitive edge the companies that list in U.S. markets enjoy").

Private enforcement of U.S. securities laws is not responsible for increased competition from foreign capital markets. Rather, as the SEC has long recognized, such

enforcement is crucial to preserving the integrity and thus the preeminence of U.S. markets. For all of the foregoing reasons, public policy considerations do not weigh in favor of reading the PSLRA pleading requirement in the strictest possible manner.

CONCLUSION

The Council does not endorse a particular interpretation of the PSLRA's requirement that plaintiffs plead facts giving rise to a "strong inference" of scienter. The Council believes that judicial application of the statute should preserve the balance struck by Congress between discouraging frivolous, lawyer-driven litigation and enabling investors to recover on meritorious claims. Despite differences in interpretation among the circuits, the PSLRA has achieved those twin goals by dramatically increasing the proportion of pre-trial dismissals and institutional lead plaintiffs in securities class actions. Experience demonstrates that the most stringent reading of the pleading requirement is not necessary to allow dismissal of "strike suits" and may tilt too far in the direction of disallowing meritorious suits, which benefit investors and strengthen U.S. capital markets.

Respectfully submitted,

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March 9, 2007

No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INC. ET AL.,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,

Respondents.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

BRIEF OF THE GERMAN ASSOCIATION FOR THE PROTECTION OF SHAREHOLDERS, UNION ASSET MANAGEMENT HOLDING AG, AND THE ASSOCIATION FOR AUSTRIAN INVESTMENT COMPANIES AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF AMICI CURIAE[1]

Amici curiae submit this brief to offer the Court a perspective from foreign investors who have chosen to invest in United States markets.

The German Association for the Protection of Shareholders[2] ("DSW") is Germany's oldest and largest association for private investors. Founded in 1947, DSW now brings together the shared interests of more than 32,000 members. Furthermore, DSW is the head office of 7,000 investment clubs in Germany with approximately 5 billion Euros (approximately $6.6 billion) invested capital. DSW is a member of the European Fund and Asset Management Association ("EFAMA"), the representative association for the European investment management industry. With its head office located in Düsseldorf, Germany, DSW works to represent its members' interests in Europe and globally.

Union Asset Management Holding AG ("Union") is based in Frankfurt am Main, Germany and is the holding organization of the Union Investment Group with offices in Germany, Luxembourg, Poland, Italy, and Spain. The Union Investment Group ranks among the three leading German fund managers by market share, with fifty years of experience and almost 2,000 employees. The Group's assets under management are over 159 billion Euros (approximately $209 billion).

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[1] Pursuant to this Court's Rule 37.6, the *amici curiae* state that no counsel for any party authored this brief in whole or in part, and no person or entity other than *amici curiae*, or its counsel, has made a monetary contribution to the preparation of submission of this brief. Pursuant to Rule 37.3, the parties' letters of consent to the filing of this brief have been lodged with this court.

[2] Deutsche Schutzvereinigung für Wertpapierbesitz e.V (DSW).

Founded in 1988, the Association for Austrian Investment Companies[3] ("VÖIG") is the umbrella association of all Austrian capital and real estate investment companies. The association has total capital assets under management totalling 168 billion Euros (approximately $222 billion), with significant investments in United States markets and United States securities. VÖIG is a member of the EFAMA. The head office is seated in Vienna, Austria.

The above *amici* recognize that the oversight of regulators such as the U.S. Securities and Exchange Commission and the New York Attorney General's Office is an important means of ensuring a level playing field for all investors. We strongly believe, however, that investors' right to redress for corporate wrongdoing through individual and class actions under The Securities Act of 1933 ("1933 Act"), 15 U.S.C.A. § 77a-77aa (West, Westlaw through Jan. 2007) and The Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C.A. § 78a-78nn (West, Westlaw through Jan. 2007), is essential to deterring improper conduct and ensuring recoupment of any losses from fraud or other misconduct.

The issue raised in this case—the standard for determining scienter in securities fraud actions—is of great importance to investors. Furthermore, Union has served as lead plaintiff in a securities class action suit. Union and members of DSW and VÖIG have been and might in the future be members of a class of shareholders in a United States securities case and as such have been and may be entitled to proceeds from a settlement.

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[3] Vereinigung Österreichischer Investmentgesellschaften (VÖIG).

INTRODUCTION

This case is about scienter requirements. It is not, as supporting *amici* of Petitioners would have the Court believe, about the efficacy of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 737. Nor is the case one in which this Court is called upon to divine congressional intent from an ambiguously worded statute. In passing the PSLRA, Congress created a detailed and complex legislative scheme to accomplish its goals, including a heightened pleading standard for certain elements of securities fraud claims.

The Petitioners' supporting *amici* aggressively urge the Court to adopt an extremist scienter standard that would largely obliterate liability for securities fraud under the PSLRA. Foreign investors' interests would be disserved by such an interpretation because, contrary to Petitioners' *amici* suggestion, the PSLRA and other United States securities laws encourage foreign investment. *Amici* for Respondents and scores of other large European and global institutional investors invest in the United States securities markets. We are well aware of United States securities laws, and we believe that these laws, as currently interpreted and enforced, serve to protect our investments by policing the activities of the market.

We submit this brief in an attempt to correct misinformation provided in the briefs of Petitioners and its supporting *amici*. From our perspective, Petitioners and its *amici* unfairly and unjustly malign a private securities policing system that is not at issue in this case. We do not merely pretend to speak for foreign investors seeking a place to invest—we are in fact foreign investors and the representatives of foreign investors, who have chosen to invest in the United States markets.

ARGUMENT

I. PRIVATE SECURITIES LITIGATION COMPLEMENTS GOVERNMENTAL REGULATION

We do not share the views of Petitioners and their *amici* that the United States private securities policing system is in dire need of revision. Instead, we adopt wholeheartedly the position of *amici* in a recent case before this Court:[4]

> It has long been recognized that private litigation serves as a "necessary supplement" to public enforcement of the securities laws. *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964). According to the congressional testimony of then-Securities and Exchange Commission ("SEC") Chairman Arthur Levitt, "Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws." *Common Sense Legal Reform Act: Hearing Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Commerce*, 104th Cong. 1 (1995) (prepared statement), *available at* http://www.sec.gov/news/testimony/testarchive/1995/spch025.txt.
>
> Congress enacted the PSLRA, Pub. L. No. 104-67, 109 Stat. 737, codified at 15 U.S.C. § 77z-1 to 78u-5, to remedy perceived abuses in securities litigation. In so doing, Congress

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[4] *See* Brief of N.J. Dep't of the Treasury and Its Div. of Inv. as *Amicus Curiae* in Supp. of Resp'ts in *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336 (2005).

emphasized the important continuing role of private plaintiffs in enforcing the nation's securities laws:

> Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely on government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and other properly perform their jobs. This legislation seeks to return the securities litigation system to that high standard.

H.R. Conf. Rep. No. 104-369, at 31-32 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 730-31. In the wake of recent accounting scandals in 2001 and 2002, Congress reiterated the importance of private securities actions when enacting the Sarbanes-Oxley Act of 2002, which, among other reforms, extended the statute of limitations for securities fraud cases. *See* Pub. L. No. 107-204, Title VIII, § 804(a)(b) and (c).

Private enforcement is necessary to [the United States's] current system of regulation because . . . the SEC does not have the resources to police the entire market. *See* United States Gen. Accounting Office, *SEC Operations: Increased Workload Creates Challenges*, GAO-02-302, at 33 (Mar. 5, 2002), *available at* http://www.gao.gov/new.items/ d02302. pdf. . . .

> . . . 2001 through 2003 saw seven of the ten largest bankruptcies in this country's history—including WorldCom, Enron, Global Crossing, and Adelphia—of which at least three have led to criminal prosecutions for accounting fraud. *See* Largest Bankruptcies, 1980-Present. Infoplease (Nov. 16, 2004) *available at* http:// www.infoplease.com/ipa/A0904494.html. . . . [T]he Food and Drug Administration has become so concerned about biotechnology companies overstating the prospects of approval of new products that it has been working with the SEC to set aside its traditional secrecy about pending applications to prevent securities law violations. *See* Ross Kerber, *Regulators Outline Actions to Oversee Drug Firm's Claims: FDA, SEC Would Share Information*, BOSTON GLOBE, Feb. 6, 2004, at C3. . . . [S]ome of the most prominent names on Wall Street have recently been repeatedly entangled by SEC and other investigations involving fraudulent accounting practices,[5] the undue influence of investment banking interests on securities research,[6] and fraudulent initial public offerings allocation practices.[7] In other

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[5] *E.g.*, The SEC Charges Merrill Lynch, Four Merrill Lynch Executives with Aiding and Abetting Enron Accounting Fraud, Accounting and Auditing Enforcement Act Release No. 1742, 79 S.E.C. Docket 2533 (Mar. 16, 2003).

[6] *E.g.*, SEC Sues Merrill Lynch and Henry M. Blodget for Research Analyst Conflicts of Interest: firm and Blodget Settle With SEC, NASD, and NYSE, Release No. 18115, 80 S.E.C. Docket 319 (Apr. 28, 2003).

[7] *E.g.*, *SEC v. Credit Suisse First Boston Corp.*, [2001-2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91, 695 at 98, 123 (D.D.C. Jan. 29, 2002).

> words, *amici* overlook the most obvious explanation for any increases in litigation during the past few years: an increase in the occurrence of securities fraud.

Br. of N.J. Dep't of the Treasury, *supra* n.5, at 2-5.

II. SECURITIES LAWS DO NOT DISCOURAGE FOREIGN INVESTORS FROM INVESTING OR FOREIGN COMPANIES FROM LISTING ON U.S. MARKETS

Contrary to the arguments of Petitioners and supporting *amici*, private enforcement of United States securities laws encourages foreign investors to invest in and foreign companies to list on U.S. markets. *Amici* for Petitioners suggest that the United States capital market is becoming less competitive—losing its position relative to other capital markets—and they blame the current state of private securities-law enforcement mechanisms for this decline in competitiveness.

How such argument is relevant to the matter before the Court is unclear, but we, as investment associations and fund managers based abroad, feel compelled to respond to these arguments. *Amici* for Petitioners make two arguments:

> (1) that the private enforcement system discourages foreign companies from listing on U.S. markets[8] or encourages them to prematurely withdraw their listings;[9] and

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[8] Br. of Pet'rs 29 n.14 (Feb. 9, 2007); Br. of the Security Industrial & Financial Markets and Chamber of Commerce of the United States of America 12 (Feb. 8, 2007) ("Br. SIFM & COC").

[9] Br. for Pixelplus Co., Ltd. and Quest Software, Inc. ("Br. Pixelplus & Quest") at n.6 and accompanying text.

(2) that the private enforcement system has "driven away potential investors."[10]

In response to these assertions, we submit the following.

A. The State of the U.S. Capital Market Is Strong—Data on Global IPOs Is Misconstrued and Misrepresented

Amici for Petitioners argue that U.S. capital markets are losing competitiveness in the global market and blame this decline on class-action private enforcement mechanisms for securities laws. In support of their arguments, *amici* point to data that would suggest U.S. capital markets have collapsed in the past five years as its share of initial public offerings has declined dramatically.[11] A closer look at the data shows that the U.S. capital market in 2006 improved its position over 2005 and was just a few percentage points off of its success rate in 2000. Maria Pinelli & Joseph A. Muscat, *Global Capital Market Trends*, (Ernst & Young LLP, White Paper, Jan. 2007) *available at* http://www.ey.com/Global/download.nsf/US/Global_Capital_Market_Trends/$file/GlobalCapitalMarketTrendsWhitePaper.pdf.

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[10] Br. of New England Legal Foundation 17 (Feb. 9, 2007) ("Br. NELF"); Br. SIFM & COC 10-12.

[11] Br. SIFM & COC 10-11. *Amici* bleakly describe the U.S. capital market as follows:

> The United States' share of [IPOs] issued by foreign companies declined from 50 percent in 2000 to only 5 percent in 2005. In 2005, 24 of the 25 largest IPOs worldwide were issued in markets outside the United States, with 9 of the 10 largest IPOs issued during the first 9 months of 2006 taking place in foreign markets.

Id. at 10-11.

A more thorough examination of the IPO data issued last month by Ernst & Young reveals that U.S. markets are "highly successful" at attracting what it terms "at play" IPOs—IPOs that are not so predisposed to list domestically or regionally that the companies would at least consider listing in U.S. markets. The study revealed that the U.S. market's success rate for at-play IPOs in 2006 was 65%, representing an improvement over 2005 (58%) and comparable to the 73.1% in-play-IPO success rate in 2000, two years prior to the enactment of Sarbanes-Oxley. Ernst & Young, *Global Capital*, *supra*, at 3. The report explains that companies tend to choose to list on domestic exchanges when possible and that many markets have recently developed sufficient infrastructure, investors, and liquidity to handle more of its IPOs. *Id.* at 2.

The report also explains how critics of U.S. securities laws have overstated the significance of recent IPO-listing data in decrying the U.S. market's decreasing competitiveness: by failing to mention that 90% of companies chose to list domestically in the first half of 2006 (in line with recent historical averages); by omitting the fact that the five largest IPOs in 2005 were privatizations of French and Chinese state-owned entities; and by neglecting to discuss the relative small size and significance of most IPOs on London's Alternative Investment Market ("AIM") and how its non-UK companies' smaller market capitalization and deal size generally would have been insufficient to attract attention from U.S. analysts. *Id.* at 3; *see also* Charles D. Niemeier, Board Member, Public Co. Acctg. Oversight Bd., *American Competitiveness in International Capital Markets*¶¶ 32, 33, Background Paper for *The Atlantic*'s Ideas Tour Commemorating the Magazine's 150th Anniversary, Washington, D.C., (Sept. 30, 2006) ("Niemeier") ("Notwithstanding the significant valuation premium in the U.S., there are considerable political, cultural, and other

influences on such companies to list locally when their markets offer sufficient liquidity."), *available at* http://www.pcaobus.org/News_and_Events/Events/2006/Speech/09-30_Niemeier.aspx. In commenting on the size of most IPOs on the AIM, executive vice president of NYSE Noreen Culhane recently stated that "[m]any of the companies listed on the AIM today wouldn't come close to meeting NYSE listing standard." Greg Ip, Kara Scannell & Deborah Soloman, *In Call to Deregulate Business, a Global Twist*, WALL ST. J., Jan. 25, 2007; *see* Niemeier, *supra*, ¶ 33 (noting that as of March 2006, only 29 of AIM's 2,220 listed companies were based in the U.S., seven of which have a dual listing or otherwise trade on a U.S. market, and concluding that "[i]t's questionable whether the remaining 22 small companies could have met the threshold listing requirements in the U.S.").

B. Listing on U.S. Markets Decreases Capital Costs and Increases Value, Both of Which Are Products of the U.S. Securities Law Enforcement and Its Effect on Investor Confidence

Companies choosing to list on U.S. markets enjoy higher value for their shares (a so-called "listing premium") and lower capital costs. *See, e.g.*, Craig Doidge, G. Andrew Karolyi & Rene M. Stulz, *Why Are Foreign Firms Listed in the U.S. Worth More?* 33 (Revised, Jan. 2003) ("Doidge, Karolyi & Stulz") *available at* http://jfe.rochester.edu/02367.pdf; Rene M. Stulz, *Corporate Governance and Financial Globalization*, National Bureau of Econ. Reseach Reporter: Research Summary, Fall 2005, ("Stulz") *available at http://www.nber.org/reporter/fall05/stulz.html*; *Foreign Firms Cross-Listed in U.S. Valued Higher*, THE EXCHANGE (NYSE Newsletter, Vol. 12, No. 10), Oct. 2005 *available at* http://www.nyse.com/about/publication / 1131450075226.html. Capital-cost savings and listing premiums are significant inducements for companies to list

on U.S. markets. Doidge, Karolyi & Stulz, *supra*, at 33; Stulz, *supra*, ¶ 10; Niemeier, *supra*, ¶ 10.

The listing premium and lower capital costs offered by the U.S. markets are directly tied to the legal consequences of listing on the U.S. market. Luzi Hail & Christian Leuz, *Cost of Capital Effects and Changes in Growth Expectations around U.S. Cross-Listings* 7 (Working Paper, Oct. 2006) ("Hail & Leuz") ("U.S. disclosure requirements, exposure to SEC enforcement, and *the threat of shareholder litigation* make it harder and more costly for controlling owners and managers to extract private control benefits from outside investors.") (emphasis added) *available at* http://fic.wharton.upenn.edu/fic/papers/06/0619.pdf. Several recent studies have added further support for this position. *Id.* Investor protections in the U.S., with their panoply of enforcement mechanisms—including private enforcement through shareholder class-actions—create the inducements for companies to list in the U.S. markets. *Id.*; Niemeier, *supra*, ¶¶ 10, 19; Stulz, *supra*, ¶ 5.

As NYSE Executive Vice President Noreen Culhane explains, "Global investors feel a new-found confidence when companies are willing to accept U.S. laws and regulations, and they value those companies more." *Foreign Firms*, THE EXCHANGE ¶ 4. "It's safe to say," she continues, "that good corporate governance pays dividends." *Id.* ¶ 13.

Professor Rene Stulz understands how enforcement of securities laws is critical to U.S. markets attracting listings:

> The institutions of the country in which a firm is located affect how investors receive a return from investing in the firm. Perhaps most importantly, a country's laws specify the rights that investors

> have, and the enforcement of the laws determines the extent to which these rights are meaningful.

Stulz, *supra*, ¶ 5. Massachusetts Institute of Technology Professor Simon Johnson similarly concludes in his recent examination of the effect of law on economic outcome: "Law definitely matters," and "[c]ountries with more investor protection have better-developed financial markets and more growth." Simon Johnson, *Coase and the Reform of the Securities Markets*, BUILDING AN INFRASTRUCTURE FOR FIN. STABILITY 200 (Federal Reserve Bank of Boston, Conference Series 44), June 2000 *available* at http://www.bos.frb.org/economic/conf/conf44/.

Professor Andrew Karolyi likewise appreciates the situation: "[g]lobal investors view firms from countries with poor shareholder protection with an element of distrust—[a] U.S. listing is a way in which firms can ease this distrust." *Foreign Firms*, THE EXCHANGE, *supra*, ¶ 11. Therefore, contrary to the suggestion of Petitioners' *amici*, vigorous enforcement of securities laws encourages foreign investment in U.S. stocks. This concept is not mere theory—current data supports substantial and increasing foreign holdings of U.S. securities. *U.S. Net International Investment Position at Yearend 2005*, BEA NEWS RELEASE (U.S. Dep't of Commerce, Bureau of Econ. Analysis New Release), June 29, 2006.

C. Costs of Enforcement are Worth the Benefits to U.S. Markets, Listing Companies, and Investors

Available evidence suggests that costs of compliance with and enforcement of regulations are worth the benefits, which are increasing. Niemeier, *supra*, ¶ 30 (stating that "there is no evidence that the cost of complying with U.S. regulation, including after enactment of the Sarbanes-Oxley Act, have cut into cross-listing premium" and concluding

that "to the contrary, it has increased since 2002, when it dipped to its lowest point since 1997"). Charles D. Niemeier, Board Member of Public Company Accounting Oversight Board, correctly weighs the costs and benefits in a September 2006 paper:

> The concern on policy makers' minds everywhere has been whether the costs of regulation and enforcement in the United States—in particular, the cost of complying with new U.S. requirements relating to internal control over financial reporting—outweigh the benefits of using U.S. markets to obtain capital. To my mind, the answer is a resounding 'NO!' for many reasons, including that the U.S.'s low cost of capital reflects the effectiveness of our securities regulations.

Id. ¶ 27. He continues, "[a]vailable evidence indicates that the savings in cost of capital that companies listed on the U.S. markets enjoy is several orders of magnitude greater [than costs associated with new internal control reporting requirements]." *Id.* ¶ 32.

Moreover, Sarbanes-Oxley should also reduce the costs of enforcement, notes Niemeier, as its internal control provisions focus management and auditors on "identifying problems in a company's internal control before those problems result in material misstatements in financial reports," and "[i]f internal control weaknesses are discovered early enough, companies should have time to address the risk before a material misstatement actually occurs—that is, before investors receive and act on materially wrong information." *Id.* ¶ 39-40.

Niemeier concludes as follows:

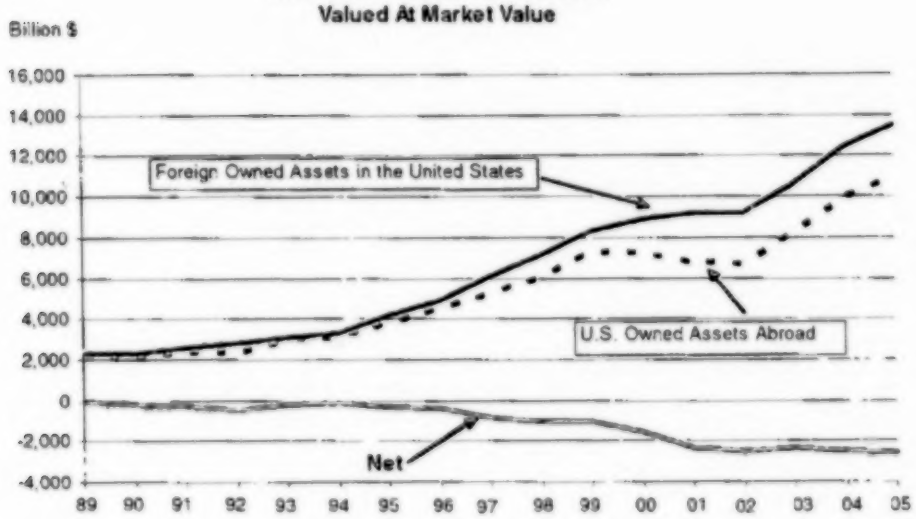
> For all these reasons, claims that the cost of securities regulation in the United States—and in particular improved investor protections adopted in and since the Sarbanes-Oxley Act—has damaged the competitiveness of U.S. companies and markets are to my mind overstated. Indeed, the U.S. financial reporting and disclosure system has strengthened U.S. markets' resilience for the long-term and contributes significantly to the competitive edge the companies that list in U.S. markets enjoy due to favorable long-term funding.

Id. ¶ 41. We concur.

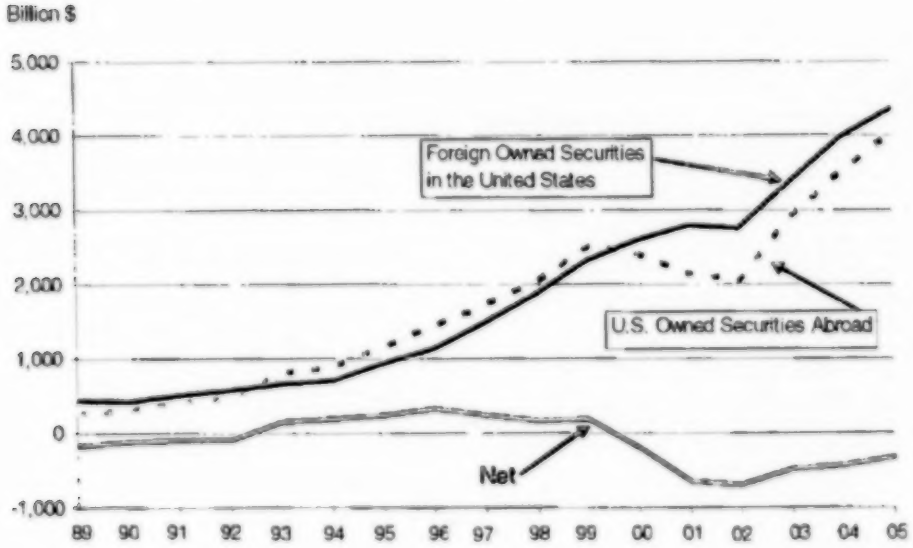
The benefits of maintaining high quality enforcement and disclosure standards are obvious: unmatched public and foreign-investor participation in the U.S. markets and record levels of foreign investment. Foreign investors appreciate the fact that, in Mr. Niemeier's words, "[i]n no other country does the general public participate in business growth opportunities to the extent that the American population does." *Id.* ¶ 6 (explaining that "half of all American households, and one in three individuals, own stocks directly or through mutual funds, up from about one-fifth in 1983"). Reassured by disclosure and enforcement standards and also the high level of U.S. public's participation in the markets, foreign investors continue purchasing U.S.-listed stocks at record levels. Elena L. Nguyen, *The International Investment Position of the United States at Yearend 2005* 9, 14-15 (Dep't. of Commerce, Bureau of Econ. Analysis, July 2006), *available at* http://www.bea.gov/scb/pdf/2006/07July/0706_IIP.pdf; *U.S. Net*, BEA NEWS RELEASE, *supra*. The foreign investment trend is demonstrated by the following graphs from the Department of Commerce, Bureau of Economic Analysis:

Net International Investment Position of the United States at Yearend. 1989 - 2005

With Direct Investment Positions Valued At Market Value



Net International Investment Position of U.S. Market Value of Corporate Securities & Bonds 1989-2005



Sources: U.S. Dep't of Commerce, Bureau of Econ. Analysis; first graph, *U.S. Net International Investment Position at Yearend 2005*, BEA NEWS RELEASE, *supra*, 4; second graph, data provided in spreadsheet on BEA website *available at* link "Yearend positions, 1976-2005" *at* http://www.bea.gov/international/index.htm.

The data show, contrary to the assertion by *amici* for Petitioners that lawsuits have driven away investors, foreign investors, in particular, believe the benefits of the existing disclosure and enforcement system are well worth its costs.

D. Fraud is Increasing Abroad, and Global Markets Are Adopting U.S. Securities Laws

Amici for Petitioners also argue that U.S. markets are losing ground to London and other international business centers and that certain businesses prefer non-U.S. legal environments. However, according to a British accounting firm, securities fraud is rampant in the United Kingdom. "British market watchers believe that shrewd charlatans, whose financial tricks are well known to U.S. authorities, are having a field day in the laid-back London scene." Paul Tharp, *Brits Get Bit—Lax British Marts Attract Fraud Along with U.S. Biz*, N.Y. Post, Jan. 8, 2007, ¶ 1. The study says that rising financial crimes cost British businesses more than $2.7 billion and that fraud claims were up 40% over 2005. *Id.*

Other commentators have issued ominous warnings about the developing capital markets. "At some point, the lack of scrutiny of corporate governance that U.S. securities law now demands is going to rebound with a vengeance," and "markets from Hong Kong to London may end up wishing they had such a law as [Sarbanes-Oxley] and the regulatory agencies that go with it." John Berthelsen, *Heading for Trouble: Asia's Unruly Stock Markets*, Asia Sentinel, Aug. 7, 2006, *available at* http://www.asiasentinel.com/index.php?option=com_content&task=view&id=79&Itemid=32.

As countries recognize the price they pay for lax standards, they are increasingly adopting U.S.-modeled securities regulations:

> Yet even as the U.S. debates whether it has gone too far, other countries are tightening their rules. The EU, Canada, Mexico, Australia, Hong Kong, Brazil, the U.K. and Germany have to varying degrees beefed up standards for audit committees. This means many companies won't escape tighter regulation by avoiding the U.S.

Ip, Scannell & Soloman, *In Call*, *supra*; *see also*, Johnson, *Coase*, *supra*, 201.

For these reasons, we submit that *amici* for Petitioners have presented inaccurate information to the Court.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

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IN THE

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INTERESTS OF AMICI[1]

Joseph A. Grundfest is the William A. Franke Professor of Law and Business at Stanford Law School, Co-Director of the Rock Center on Corporate Governance at Stanford University, and a former Commissioner of the United States Securities and Exchange Commission. Professor Grundfest's scholarship addresses the interpretation of the "strong

[1] No counsel for a party authored this brief in whole or in part, and no persons or entities, other than amici, their members, or their counsel, made a monetary contribution to the preparation or submission of this brief. Letters from the parties consenting to the filing of this brief are on file with the Clerk.

inference" standard,[2] the implied nature of the private right of action that arises under Section 10(b),[3] and the economic forces that create significant settlement leverage in high variance litigation.[4] Professor Grundfest is also a director and co-founder of Financial Engines, Inc., the parent of a federally registered investment adviser, which as of January 31, 2007, had more than $8.3 billion in assets under management. In the event that Financial Engines were to engage in a public offering of its shares, its officers and directors would become subject to the PSLRA's strong inference pleading standard.

Arthur Rock has been described as one of the founding fathers of venture capital in the United States, and has been credited with coining the term "venture capital." Mr. Rock and his firms have provided early stage financing to Intel, Apple Computer, Teledyne, Scientific Data Systems, General Transistor, and Diasonics, as well as to dozens of other technology firms.

Genentech, Inc. is a leading biotechnology company that discovers, develops, manufactures, and commercializes biotherapeutics for significant unmet medical needs. Genentech had a market capitalization of approximately $91 billion as of January 31, 2007.

Intel Corp. is the world's largest semiconductor chip maker. Intel develops advanced integrated digital technology platforms for the computing and communications industries. Intel's market capitalization as of January 31, 2007, was approximately $121 billion.

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[2] Grundfest & Pritchard, *Statutes With Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 Stan. L. Rev. 627 (2002).

[3] Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 Harv. L. Rev. 961 (1994); Grundfest, *Why Disimply? Commentaries*, 108 Harv. L. Rev. 727 (1995).

[4] Grundfest & Huang, *The Unexpected Value of Litigation: A Real Options Perspective*, 58 Stan. L. Rev. 1267 (2006).

The NASDAQ Stock Market, Inc. (NASDAQ®) is the largest electronic screen-based equity securities market in the United States. With approximately 3,200 companies, it lists more companies and, on average, trades more shares per day than any other U.S. market. It is home to companies that are leaders across all areas of business including technology, retail, communications, financial services, transportation, media, and biotechnology. NASDAQ is the primary market for trading NASDAQ-listed stocks. NASDAQ is also itself a publicly traded entity and had a market capitalization of approximately $3.8 billion as of January 31, 2007.

Netflix, Inc. is the world's largest online movie rental service, providing more than five million subscribers access to over 70,000 DVD titles. Netflix had a market capitalization of approximately $1.5 billion as of January 31, 2007.

Synopsys, Inc. develops and distributes electronic design automation software and related services for semiconductor design companies. Synopsys shares had a total market capitalization of approximately $3.8 billion as of January 31, 2007.

As publicly traded firms, Genentech, Intel, NASDAQ, Netflix, and Synopsys are each potentially subject to implied private rights of action that would be governed by the PSLRA's strong inference pleading standard.

SUMMARY OF ARGUMENT

The pertinent requirement of the PSLRA—that a private complaint under Rule 10b-5 must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind"—imposes a high standard for pleading scienter. Three circumstances individually and collectively require a strict reading of the PSLRA.

First, the private cause of action was "implied" (judicially created), by a procedure this Court would no longer endorse, and the courts therefore have had to perform the essentially legislative task of defining the elements and boundaries of the cause of action. This circumstance alone

suggests that the cause of action should be narrowly construed on any point where its scope is otherwise in doubt, rather than allow the judicially created cause of action to enlarge through judicial interpretation that, by definition, cannot be rooted in congressional direction.

Second, the Court has repeatedly recognized that the private cause of action poses a special "danger of vexatiousness" and has interpreted it narrowly to combat that danger. The requirement of proof of " 'scienter'—intent to deceive, manipulate, or defraud" is one of the several important barriers this Court has erected against that danger. The scienter requirement operates effectively as a barrier against vexatious litigation only if it is significant at the pleading stage.

Third, Congress recognized in the PSLRA precisely the dangers that this Court had long seen in the Rule 10b-5 cause of action, and it enacted the "particularity" and "strong inference" requirements for the purpose of combating them. The Court recognized this congressional purpose last Term in *Merrill Lynch, Pierce, Fenner & Smith* v. *Dabit*, 126 S. Ct. 1503, 1510 (2006), and the purpose is plain from the text of the PSLRA provision and the circumstances of its enactment, regardless of the competing phrases injected into the formal legislative history by Members of Congress with varying individual points of view.

A "strong inference" from particular alleged facts means an inference that emerges, after comparison with possible competing inferences, as significantly or substantially more likely than not to be true. An "inference" is a " 'conclusion reached by considering other facts and deducing a logical consequence from them.' " *Johnson* v. *California*, 545 U.S. 162, 168 n.4 (2005) (quoting Black's Law Dictionary 781 (7th ed. 1999)). The word may sometimes be used more casually, but the Court properly assumes that Congress uses such a word in its formal sense, and the statutory requirement of a "strong" inference removes any doubt.

Alleged facts cannot give rise to a strong inference of scienter if they equally imply other possibilities inconsistent

with such intent. The court of appeals therefore committed a serious error when it declined to consider alternative "innocent" inferences. Scienter cannot be a "strong" logical deduction from alleged facts unless it is significantly or substantially more likely than not to be true, and a court cannot make that determination if it ignores other possibilities.

The court of appeals also erred in concluding that it should give a softer and nonliteral reading to "strong inference" in order to avoid a potential issue under the Seventh Amendment. The PSLRA does not, on any interpretation of the clause at issue, take any factual determination away from the jury and give it to the judge. The statute simply defines one pleading requirement for a federal cause of action, something Congress is entirely free to do without impinging on the Seventh Amendment, as other pleading requirements and procedural barriers to getting a case to the jury make clear.

ARGUMENT

I. THE HISTORY OF THE RULE 10b-5 CAUSE OF ACTION STRONGLY REINFORCES PETITIONERS' ARGUMENT THAT THE "PARTICULARITY" AND "STRONG INFERENCE" REQUIREMENTS OF THE PSLRA EMBODY A HIGH STANDARD FOR PLEADING SCIENTER

Section 21D of the Securities Exchange Act of 1934 ("1934 Act"), which was added by the Private Securities Litigation Reform Act ("PSLRA"), requires the plaintiff, in a private action under the 1934 Act, to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). The court "shall . . . dismiss the complaint" if that pleading requirement is not met. *Id.* § 78u-4(b)(3)(A). In the case of a Rule 10b-5 cause of action, the required state of mind is " 'scienter'—intent to deceive, manipulate, or defraud." *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 193 (1976).[5] Nevertheless, the court of appeals in this case ruled

[5] We note that this Court has reserved its view on whether scienter includes recklessness; all courts of appeals that have considered the ques-

that a private Rule 10b-5 complaint will survive dismissal "if it alleges facts from which, if true, a reasonable person *could* infer that the defendant acted with the required intent." Pet. App. 20a (emphasis added). This hardly differs from the pre-PSLRA pleading standard. *See Swierkiewicz* v. *Sorema N.A.*, 534 U.S. 506, 514 (2002) ("Given the Federal Rules' simplified standard for pleading, [a] court may dismiss a complaint only if it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations." (internal quotation marks and citation omitted; alteration in original)); *cf. Patton* v. *Przybylski*, 822 F.2d 697, 700 (7th Cir. 1987) (affirming dismissal under Federal Rule of Civil Procedure 12(b)(6) because "no reasonable finder of facts could, we think, infer that [the defendant] acted unreasonably").

The whole history of the Rule 10b-5 cause of action suggests that the court below erred and that the "particularity" and "strong inference" requirements should be understood to erect a high requirement for pleading scienter. Three points stand out in this respect. First, the Rule 10b-5 cause of action is a judicial creation, whose elements remain defined entirely by the courts. Second, in exercising its responsibility to define and limit the Rule 10b-5 cause of action, this Court has been vigilant to protect against abusive use of this judicial creation. Third, Congress, in enacting the PSLRA, acted against the background of this Court's cases embracing such vigilance, and acted out of similar concerns.

A. The Rule 10b-5 Cause Of Action Is A Judicial Creation

The courts created the private cause of action for violations of Rule 10b-5. Although this Court recognized in 1983

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tion have held that it does; and the circuits appear to be split on what constitutes recklessness for this purpose. *See* Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 Harv. L. Rev. 961, 1012 (1994). The PSLRA seems carefully to preserve this issue for this Court, by referring to "the required state of mind," 15 U.S.C. § 78u-4(b)(2).

that the existence of this implied cause of action was "simply beyond peradventure," *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 380 (1983), the Court has also repeatedly recognized, both before and since 1983, that "there is no indication that Congress, or the Commission, when adopting Rule 10b-5, contemplated such a remedy," *Hochfelder*, 425 U.S. at 196 (footnotes omitted); *see also Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 501 U.S. 350, 359 (1991) ("[W]e have made no pretense that it was Congress' design to provide the remedy afforded."). As the Court acknowledged only last Term, then-Justice Rehnquist in 1975 aptly "described the rules governing private Rule 10b-5 actions" as "the 'judicial oak which ha[d] grown from little more than a legislative acorn.'" *Merrill Lynch*, 126 S. Ct. at 1510 (quoting *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 737 (1975)) (alteration in original).[6]

Indeed, if the Court's current view about finding implied private causes of action in federal statutes, *see, e.g.*, *Touche Ross & Co.* v. *Redington*, 442 U.S. 560 (1979), had been in place when the issue was first decided, it seems highly unlikely that the Court would have "confirmed with virtually no discussion . . . that such a cause of action did exist," *Blue Chip Stamps*, 421 U.S. at 730 (citing *Superintendent of Ins.* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 150-154 (1972)). As Justice Scalia noted in *Holmes* v. *Securities Investor Protection Corp.*, 503 U.S. 258 (1992), "[T]he contours of a Rule 10b-5 action" were " 'implied' (*i.e.*, created) by the Court itself—a practice we have since happily abandoned[.]" *Id.* at 289 (Scalia, J., concurring in judgment) (citing *Touche Ross & Co.*, 442 U.S. at 568-571, 575-576). *See generally* Ruder, *Civil Liability Under Rule 10b-5: Judicial*

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[6] For an analysis of the history of the section 10(b) implied right of action, *see* Grundfest, *supra* n.5, at 985-998.

Revision of Legislative Intent?, 57 Nw. U. L. Rev. 627 (1963).[7]

The fact that the Rule 10b-5 cause of action is "of judicial creation," *Lampf*, 501 U.S. at 358, has meant that the courts have had the responsibility for defining its elements. As this Court has recognized, because "Congress did not create a private § 10(b) cause of action [it] had no occasion to provide guidance about the elements of a private liability scheme." *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994); *see also Musick, Peeler & Garrett* v. *Employers Ins. of Wausau*, 508 U.S. 286, 292 (1993) ("The federal courts have . . . exercised the principal responsibility for the continuing elaboration of the scope of the 10b-5 right and the definition of the duties it imposes."). As this Court has also recognized, the fact that the cause of action was judicially created, by a process this Court would not now endorse, provides a reason for choosing narrow rather than broad readings of the right. *See Blue Chip Stamps*, 421 U.S. at 748-749 ("We are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the ques-

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[7] Since the 1970s, this Court has repeatedly cautioned "that private parties may employ . . . an implied private right of action only if they demonstrate an 'unambiguously conferred right.' " *Pharmaceutical Research & Mfrs. of Am.* v. *Walsh*, 538 U.S. 644, 683 (2003) (Thomas, J., concurring in judgment) (quoting *Gonzaga Univ.* v. *Doe*, 536 U.S. 273, 283 (2002)); *see Alexander* v. *Sandoval*, 532 U.S. 275, 286-287 (2001) (stating that without congressional "intent to create not just a private right but also a private remedy . . . a cause of action does not exist and courts may not create one, no matter how desirable that might be as a policy matter, or how compatible with the statute"); *Virginia Bankshares, Inc.* v. *Sandberg*, 501 U.S. 1083, 1102 (1991) ("[A]ny private right of action for violating a federal statute must ultimately rest on congressional intent to provide a private remedy." (citing *Touche Ross & Co.*, 442 U.S. at 575)); *California* v. *Sierra Club*, 451 U.S. 287, 297 (1981) ("The federal judiciary will not engraft a remedy on a statute, no matter how salutary, that Congress did not intend to provide."); *Touche Ross & Co.*, 442 U.S. at 575 ("The central inquiry [is] whether Congress intended to create, either expressly or by implication, a private cause of action.").

tion."); *cf. Gebser* v. *Lago Vista Indep. Sch. Dist.*, 524 U.S. 274, 284 (1998) ("Because the private right of action under Title IX is judicially implied, we have a measure of latitude to shape a sensible remedial scheme[.]").

B. This Court Has Been Vigilant To Protect Against Abusive Use Of This Judicially Created Cause Of Action

In exercising its responsibility to define the judicially created Rule 10b-5 cause of action, this Court has repeatedly emphasized the particular dangers this remedy poses, and has cabined the cause of action to protect against those dangers, proceeding both cautiously and out of deference to the proper role of Congress. Only four years after first recognizing the Rule 10b-5 cause of action in *Superintendent of Insurance*, 404 U.S. at 13 n.9, the Court took note of the "widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps*, 421 U.S. at 739. "[I]n this type of litigation, . . . the mere existence of an unresolved lawsuit has settlement value to the plaintiff not only because of the possibility that he may prevail on the merits, . . . but because of the threat of extensive discovery and disruption of normal business activities which may accompany a lawsuit which is groundless in any event, but cannot be proved so before trial[.]" *Id.* at 742-743.

It was "principally [such] 'policy considerations,'" "which the Court [in *Blue Chip Stamps*] viewed as appropriate in explicating a judicially crafted remedy," that underlay the decision "to limit the private remedy . . . by means of the purchaser-seller limitation." *Merrill Lynch*, 126 S. Ct. at 1510 (quoting *Blue Chip Stamps*, 421 U.S. at 737); *see also id.* (stating that the Court sought to "minimize the[] ill effects" that would be engendered by a broader cause of action); *Virginia Bankshares*, 501 U.S. at 1104-1105 ("Faced in [*Blue Chip Stamps*] with . . . rounding out the scope of an implied private statutory right of action, we

looked to policy reasons for deciding where the outer limits of the right should lie.").

These same concerns have consistently animated other decisions in which this Court has limited the Rule 10b-5 cause of action and other private causes of action under the 1934 Act. For example, in *Hochfelder*, in reaching the conclusion that no cause of action will lie under Rule 10b-5 unless there is an allegation of " 'scienter'—intent to deceive, manipulate, or defraud," 425 U.S. at 193, the Court "consider[ed] it significant that each of the express civil remedies in the 1933 Act allowing recovery for negligent conduct . . . is subject to significant procedural restrictions," *id.* at 209. Citing *Blue Chip Stamps*, 421 U.S. at 740-741, the Court noted that "Congress regarded these restrictions as significant" and that "[o]ne of [the] purposes" of such restrictions "was to deter actions brought solely for their potential settlement value." *Hochfelder*, 425 U.S. at 210 n.30. The Court thus recognized, as it had the Term before in *Blue Chip Stamps*, that barriers against vexatious litigation are generally only effective at the pleading stage because after this point "even a complaint which by objective standards may have little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial." 421 U.S. at 740; *see also id.* at 741 (expressing concern about the "potential for possible abuse of the liberal discovery provisions of the Federal Rules of Civil Procedure" in securities fraud cases).

More recently, in *Dura Pharmaceuticals Inc.* v. *Broudo*, 544 U.S. 336 (2005), the Court unanimously rejected an argument that a private plaintiff adequately alleges loss causation under Rule 10b-5 by alleging that the price of a security on the date of purchase was inflated, explaining, *inter alia*, that such an approach "would permit a plaintiff 'with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the discovery process

will reveal relevant evidence.'" *Id.* at 347 (quoting *Blue Chip Stamps*, 421 U.S. at 741) (alteration incorporated).

The Court sounded the same theme in *Virginia Bankshares*, 501 U.S. at 1104-1105, rejecting respondents' theory of causation there. The Court noted that "[t]his is not the first effort in recent years to expand the scope of an action originally inferred from the Act without conclusive guidance from Congress." It observed that "*Blue Chip Stamps* set an example worth recalling," and expressed concern about "the same threats of speculative claims." *Id.* (internal quotation marks and citation omitted). The Court made a similar point in *Central Bank of Denver*, 511 U.S. at 188-189, concluding that Rule 10b-5 does not provide a private cause of action against aiders and abettors. The Court repeated that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general," and it expressed concern that such litigation "requires secondary actors to expend large sums even for pretrial defense and the negotiation of settlements." *Id.* at 189 (internal quotation marks and citations omitted).

The Court expressed comparable concerns in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976), unanimously[8] rejecting the argument that a material fact is one "which a reasonable shareholder *might* consider important." *Id.* at 449 (emphasis in original). Such a standard, the Court explained, was "'too suggestive of mere possibility,'" *id.* (quoting *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1302 (2d Cir. 1973)), threatening to change management's behavior for the worse out of "fear of exposing itself to substantial liability" "for insignificant omissions or misstatements," *id.* at 448. The Court therefore held that a fact "is material [only] if there is a substantial likelihood that a rea-

[8] Justice Stevens took no part in the consideration or decision of the case. *Id.* at 464.

sonable shareholder *would* consider it important." *Id.* at 449 (emphasis added).[9]

C. In Enacting The PSLRA, Congress Acted Against The Background Of The Cases In Which This Court Expressed Concern About The "Danger Of Vexatiousness," And Congress Acted With Similar Concerns

Scholars have noted that the "formal" legislative history of the PSLRA is susceptible to multiple interpretations and that it contains conflicting remarks about congressional intentions, reflecting the hopes of different Senators and Representatives. *See, e.g.*, Grundfest & Pritchard, *Statutes With Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 Stan. L. Rev. 627, 655-660 (2002). But there is a less manipulable and surer guide to congressional intent and the proper interpretation of the PSLRA: the long history of the concerns this Court has expressed with regard to the private cause of action under Rule 10b-5, and Congress's clear recognition of the same concerns.

In the first place, when Congress legislates against the background of a well-established judicial interpretation of a statute, Congress is presumed to be aware of the interpretation and to assume it. *See, e.g., Commissioner* v. *Keystone Consol. Indus., Inc.*, 508 U.S. 152, 159 (1993) (stating "Congress presumptively was aware" of "settled judicial and

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[9] Two recent decisions in which the Court took an arguably more expansive approach are readily distinguishable, as both involved interpretation of the reach of section 10(b) rather than definition of the implied private right of action. *See SEC* v. *Zanford*, 535 U.S. 813, 819-820 (2002) (Court deferred to the SEC's interpretation in a formal adjudication of the phrase in section 10(b) "in connection with the purchase or sale of any security" (quoting 15 U.S.C. § 78j)); *Wharf Holdings, Ltd.* v. *United Int'l Holdings, Inc.*, 532 U.S. 588, 595 (2001) (Court rejected petitioner's principal contention that its conduct fell outside the scope of the statute because the agreement at issue was oral, stating that the Securities Exchange Act of 1934 "says that it applies to 'any contract' for the purchase or sale of a security" (citing 15 U.S.C. § 78c(a)(13))).

administrative interpretation [of relevant terms] over the course of a half century" in adopting a statute); *Lorillard* v. *Pons*, 434 U.S. 575, 581 (1978) ("[W]here . . . Congress adopts a new law incorporating sections of a prior law, Congress normally can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute."). The same should be true, *a fortiori*, where Congress legislates against the background of extensive case law dealing with a judicially created cause of action. "It is always appropriate to assume that our elected representatives, like other citizens, know the law." *Traynor* v. *Turnage*, 485 U.S. 535, 546 (1988) (internal quotation marks and citation omitted).

Moreover, in this instance there is ample evidence that Congress was in fact aware of the concerns this Court had expressed, and that it was motivated by the same concerns. This Court said last Term, "Policy considerations similar to those that supported the Court's decision in *Blue Chip Stamps* prompted Congress, in 1995, to adopt legislation targeted at perceived abuses of the class-action vehicle in litigation involving nationally traded securities." *Merrill Lynch*, 126 S. Ct. at 1510. The Court cited "the House Conference Report accompanying what would later be enacted as the [PSLRA]," *id.*, for the proposition that "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and 'manipulation by class action lawyers of the clients whom they purportedly represent' had become rampant in recent years," *id.* at 1510-1511 (quoting H.R. Rep. No. 104-369, at 31 (1995)). The Court has explained that, in an "effort to curb these perceived abuses," the PSLRA "imposes heightened pleading requirements in actions brought pursuant to § 10(b) and Rule 10b-5," *id.* at 1511, "insist[ing] that securities fraud complaints 'specify' each misleading statement . . . and that they 'state with particularly facts giving rise to a strong inference that the defendant acted with the required state of mind,'" *Dura Pharms.*, 544 U.S. at 345 (quoting 15 U.S.C. § 78u-4(b)(1), (2)).

It is critically important that Congress required plaintiffs to *plead* the required facts, and that it required them to plead such facts *with particularity*. If Congress had merely set a high scienter standard for the factfinder, but had allowed plaintiffs to follow the ordinary rules of notice pleading, it would not have dealt with the central problem, which is that in securities cases an undismissed complaint coupled with the ability to take discovery gives the plaintiff extraordinary leverage. As this Court said in *Blue Chip Stamps*, "even a complaint which by objective standards may have little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial," 421 U.S. at 740, in part because of the "potential for possible abuse of the liberal discovery provisions of the Federal Rules of Civil Procedure" in securities fraud cases, *id.* at 741. There is, particularly in large class actions, what Judge Friendly called the danger of "blackmail settlements." Henry J. Friendly, *Federal Jurisdiction: A General View* 120 (1973).[10] Nonmeritorious cases can be stopped at the threshold only if the plaintiffs are required not merely to provide strong *proof* of scienter but to plead it with particularity at the outset.[11]

Congress has carefully followed the courts' work and responded to it on other issues arising under Rule 10b-5. As the Court said in *Musick*, 508 U.S. at 293, the judiciary's "cumulative work in [the] design" of the Rule 10b-5 cause of action has been closely watched by Congress. After the Court "resol[ved] . . . a difficult statute of limitations issue for 10b-5 suits [in *Lampf*]," for example, "Congress inter-

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[10] For an analysis of some of the reasons why securities fraud class actions often create unjustified pressures to settle, see Grundfest & Huang, *supra* n.4.

[11] *Cf. In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351, 370 (S.D.N.Y. 2003) ("These provisions mandate a school of realism, not impressionism. Plaintiffs must set forth *with particularity each* statement they assert was fraudulent and why, in their view, the statement was fraudulent—specifying who made it and where and when it was made." (emphasis in original)).

vened by limiting the retroactive effect of [the] decision." *Id.* (citing 15 U.S.C. § 78aa-1). Similarly, in the PSLRA itself, Congress clarified that the SEC could bring suit against aiders and abettors under section 10(b) in civil enforcement actions, *see* Pub. L. No. 104-67, 109 Stat. 737, 757 (1995) (codified at 15 U.S.C. § 78t(e)), an issue not resolved in *Central Bank of Denver*, *see* 511 U.S. at 199-200 (Stevens, J., dissenting). Given Congress's actions, and "the peculiar blend of legislative, administrative, and judicial history which ... surrounds Rule 10b-5," *Blue Chip Stamps*, 421 U.S. at 749, "it is not only appropriate but also realistic to presume that Congress was thoroughly familiar with the[] unusually important precedents from [this Court] and other federal courts and that it expected its enactment to be interpreted in conformity with them," *Cannon* v. *University of Chicago*, 441 U.S. 677, 699 (1979).

Scholars have recognized what Congress plainly did in enacting the PSLRA. "The [PSLRA] was clearly a product of th[e] sense that securities class actions were disproportionately nonmeritorious." Coffee, *Reforming The Securities Class Action: An Essay On Deterrence And Its Implementation*, 106 Colum. L. Rev. 1534, 1534 n.1 (2006).

> In enacting the PSLRA, Congress announced this view explicitly, stating in the legislative history that among the PSLRA's purposes was the desire to end the "routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action."

Id. (quoting H.R. Rep. No. 104-369, at 31 (1995)).

In sum, this Court should interpret the provisions of the PSLRA in a way that serves the end the Court has long articulated and that Congress plainly recognized in enacting the statute: stopping weak cases and fishing expeditions before discovery. The Court should rule, first, that the

statutory requirement that a complaint must state scienter "facts" "with particularity" means that the facts must be specific and genuinely factual, rather than conclusory. *See, e.g., Florida State Bd. of Admin.* v. *Green Tree Fin. Corp.*, 270 F.3d 645, 660 (8th Cir. 2001) ("[W]hereas under Rule 12(b)(6), we must assume all factual allegations in the complaint are true, . . . under the [PSLRA], we disregard 'catch-all' or 'blanket' assertions that do not live up to the particularity requirements of the statute."). The Court should rule, second, that to satisfy the "strong inference" requirement these allegations of particular facts must be sufficient to persuade the trial court that, if they are later proved true, the plaintiffs will have demonstrated intent to deceive, manipulate, or defraud, *see Hochfelder*, 425 U.S. at 193, 193 n.12. Amici take up the meaning of "strong inference" further below.

II. A "STRONG INFERENCE" FROM PARTICULAR ALLEGED FACTS MEANS AN INFERENCE THAT EMERGES, AFTER COMPARISON WITH POSSIBLE COMPETING INFERENCES, AS SIGNIFICANTLY OR SUBSTANTIALLY MORE LIKELY THAN NOT TO BE TRUE

English usage and logic confirm that the PSLRA's "strong inference" requirement sets a high hurdle for pleading a Rule 10b-5 cause of action. They suggest that an inference based on particular alleged facts can be "strong" only if it emerges, after comparison with competing inferences from the same facts, as significantly or substantially more likely than not to be true.

An "inference" is a " 'conclusion reached by considering other facts and deducing a logical consequence from them.' " *Johnson* v. *California*, 545 U.S. 162, 168 n.4 (2005) (quoting Black's Law Dictionary 781 (7th ed. 1999)); *see also NLRB* v. *Curtin Matheson Scientific, Inc.*, 494 U.S. 775, 814-815 (1990) (Scalia, J., dissenting) (defining "inference" as "[a] process of reasoning by which a fact or proposition sought to be established is deduced as a logical consequence from other facts, or a state of facts, already proved or admitted") (quoting Black's Law Dictionary 700 (5th ed. 1979)); American Heritage College Dictionary 710 (4th ed. 2002) (defining

"inference" as "[t]he act or process of deriving logical conclusions from premises known or assumed to be true"). As applied to the PSLRA provision in question, the definition means that scienter must logically follow from the facts pleaded "with particularity" in the complaint.

Congress deliberately added the word "strong."[12] "Strong" is a word of many meanings, but in this context the applicable definition is "urgent, compelling." Webster's Third New International Dictionary 2265 (2002). *See also Helwig* v. *Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) ("defining 'strong' as 'cogent, powerful, forcible, forceful' ") (quoting Black's Law Dictionary 1423 (6th ed. 1990)); American Heritage College Dictionary 1346 (3d ed. 1997) ("[p]ersuasive, effective, and cogent"). Thus the inference, from the facts pleaded with particularity in the complaint, must be not only logical but "compelling," "persuasive, ... and cogent." The question for a district court is whether, assuming the truth of the particular facts pleaded, it follows compellingly, or in the alternative formulation persuasively and cogently, as a matter of logic and experience, that the defendants acted with the required intent to deceive.

A court cannot make that determination without considering, and rejecting as less persuasive and cogent, alternative hypotheses that involve no intent to deceive. *Cf.* John R. Platt, *Strong Inference*, 146 Sci. 347, 347 (1964) (in science, "[s]trong inference" consists of "[d]evising alternative hypotheses" and systematically excluding them by experiments). "Scienter" cannot be said to follow "persuasively and cogently" from pleaded facts if the same facts equally, or nearly equally, support an inference that there was no scienter. By requiring the district court to find that, assuming the pleaded particular facts, and after consideration of alternative hypotheses, the inference of scienter is significantly

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[12] "That the statute, by its terms, requires a 'strong,' rather than merely a 'reasonable,' inference that the defendant acted with scienter is more than an odd linguistic quirk." *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 48 (1st Cir. 2005).

or substantially more likely than the inference of no scienter, this Court can give independent substance to the statutory mandate that the inference of scienter be "strong" and not merely reasonable or credible.[13]

The facts in *Gompper* v. *VISX, Inc.*, 298 F.3d 893 (9th Cir. 2002), are illustrative. Plaintiffs there sued a corporation for securities fraud, alleging that the corporation knew that its core patents were invalid and hence that its revenue projections were false or misleading. The complaint alleged that the corporation was aggressively suing its competitors for patent infringement and that this aggressiveness justified an inference that the corporation knew its patents were invalid and was trying to intimidate its competitors through litigation. But the Ninth Circuit ruled that an equally plausible inference was that the corporation consistently asserted its patents in litigation because it believed the patents were valid and recognized that the patented technology was key to its business. "Consideration of this [competing] inference quite clearly impedes the plaintiffs' progress toward building the requisite strong inference of scienter." *Id.* at 897. The court could not assess the strength of the proffered inference without considering competing ones. To require a court to consider only inferences favorable to a plaintiff's position would be to "eviscerate the PSLRA's strong inference requirement by allowing plaintiffs to plead in a vacuum." *Id.* at 896. Whatever the precise formulation, the statutory requirement demands that a claim be dismissed unless the inference of scienter is significantly more likely than competing no-scienter inferences.

Because the "strong inference" standard requires consideration of all competing inferences from the facts pleaded,

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[13] The Court has found the words "significant" and "substantial" useful in defining the term "materiality" in securities law contexts. *TSC Indus., Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976) ("[T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.").

lower court decisions suggesting that particular fact patterns (such as motive and opportunity) automatically establish a strong inference of scienter[14] are inconsistent with a proper reading of the Act. Nowhere does the statute say that motive and opportunity always suffice. Rather, in adopting the heightened pleading standard of the PSLRA, Congress was concerned with the quantum and particularity, not the category, of facts pleaded. *See, e.g., Helwig*, 251 F.3d at 551. A court must consider whether, of all the competing inferences from all of the facts pleaded, the inference of scienter is significantly the most likely.

III. THE PSLRA DOES NOT VIOLATE THE SEVENTH AMENDMENT

The Seventh Circuit based its erroneous reading of the "strong inference" requirement partly on a concern that a more stringent reading might violate the Seventh Amendment's civil jury trial guarantee. *See* Pet. App. 20a. That concern is unfounded.

The Seventh Amendment bars Congress from directing that a judge, rather than the jury, will decide any factual issue arising in a civil case to which it applies. The PSLRA does not do that. To the contrary, it specifies that the plaintiffs must *plead* certain kinds of facts in order to have a valid cause of action. Congress has ample power to control access to the lower federal courts, including the power to define what must be pleaded in order to state a federal case. *Compare* Fed. R. Civ. P. 9(b) (requiring that "the circumstances constituting fraud or mistake shall be stated with particularity"). Courts have not hesitated to dismiss complaints for failure to meet the "particularity" requirement of Rule

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[14] *E.g., Rombach* v. *Chang*, 355 F.3d 164, 176 (2d Cir. 2004) (to satisfy the strong inference requirement, " 'a complaint may . . . allege facts to show that defendants had both motive and opportunity to commit fraud' " (quoting *Rothman* v. *Gregor*, 220 F.3d 81, 90 (2d Cir. 2000))); *Kalnit* v. *Eichler*, 264 F.3d 131, 138-139 (2d Cir. 2001) ("the PSLRA did not change the basic pleading standard for scienter in this circuit"; therefore a plaintiff may demonstrate scienter "with motive and opportunity allegations" (internal quotation marks and citations omitted)).

9(b).[15] Indeed, Congress's power to impose heightened pleading requirements has never been questioned. *E.g.*, *Swierkiewicz*, 534 U.S. at 512-513; *Leatherman* v. *Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 168 (1993). The Seventh Amendment "does not attempt to regulate matters of pleading or practice."[16]

There are numerous contexts in which judicial determinations can prevent claims from reaching juries, without violating the Seventh Amendment. These include summary judgment, *see* Fed. R. Civ. P. 56; 10A Wright, Miller & Kane, *Federal Practice and Procedure: Civil 3d* § 2714 (1998) ("[O]nce the court determines that there are no disputed material facts, it is free to enter a judgment on the basis of a determination of the governing legal issues and doing so does not deprive the opposing party of the right to a jury trial."); and judgment as a matter of law, *see* Fed. R. Civ. P. 50. *Cf. Dimick* v. *Schiedt*, 293 U.S. 474, 482-483 (1935) (remittitur is consistent with Seventh Amendment where prevailing party is offered the option of a new trial); *Daubert* v. *Merrell Dow Pharms., Inc.*, 509 U.S. 579, 590 (1993) (expert testimony can be excluded based on judicial determination of reliability).

When a court determines whether a complaint meets the applicable pleading requirements, it does not decide any fact issue. Rather, it determines whether plaintiffs have pleaded the required facts and thus are entitled to offer evidence to support their claims. *Cf. Scheuer* v. *Rhodes*, 416 U.S. 232, 236 (1974) ("The issue is not whether a plaintiff will

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[15] *See, e.g., Carroll* v. *Fort James Corp.*, 470 F.3d 1171 (5th Cir. 2006); *California Pub. Employees' Ret. Sys.* v. *Chubb Corp.*, 394 F.3d 126 (3d Cir. 2004); *In re Rockefeller Ctr. Props., Inc. Sec. Litig.*, 311 F.3d 198 (3d Cir. 2002).

[16] *Walker* v. *New Mexico*, 165 U.S. 593, 596 (1897) (dictum) (upholding procedural rule that allowed judge to enter judgment based on jury's answers to special interrogatories if inconsistent with general verdict); *see also Baltimore & Carolina Line, Inc.* v. *Redman*, 295 U.S. 654, 657 (1935) (Seventh Amendment is not implicated where mere matters of procedure and issues of law are concerned).

ultimately prevail but whether claimant is entitled to offer evidence to support the claims."), *overruled on other grounds*, *Harlow* v. *Fitzgerald*, 457 U.S. 800 (1982). If the applicable pleading requirements are not met, the complaint is properly dismissed for failure of pleading. In that situation, the court has not decided any factual issue, and there are no facts to be tried by the jury; thus, the right to a jury trial is not implicated. *See Smith* v. *Kitchen*, 156 F.3d 1025, 1029 (10th Cir. 1998) (dismissal of complaint did not implicate Seventh Amendment because plaintiff failed to plead any facts that would overcome defendants' defenses, so there were no facts to be tried by a jury); *Raul* v. *American Stock Exch.*, Nos. 95 Civ. 3154 (SAS), 95 Civ. 8361 (SAS), 1996 WL 627574, at *2 (S.D.N.Y. Oct. 29, 1996) (dismissal of complaint did not violate Seventh Amendment because plaintiff failed to state an actionable claim and thus "never fell within the aegis of the Seventh Amendment, and was never entitled to a jury trial"). The Seventh Amendment is simply irrelevant to the interpretation of the "strong inference" requirement in the PSLRA.

CONCLUSION

For these reasons, the decision below should be reversed.

Respectfully submitted,

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FEBRUARY 2007

No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD NOTEBAERT,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR AMICI CURIAE ALLAN N. LITTMAN AND WILLIAM I. EDLUND IN SUPPORT OF THE POSITION OF RESPONDENTS

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INTEREST OF AMICI CURIAE[1]

Amici Curiae are members of the Bar of the State of California and of this Court. Each has been practicing law for over fifty years. They have defended and brought claims against corporate officers, investment bankers and accountants in securities and fraud actions, and represented Federal and State agencies in auditing matters. They are familiar with the duties and legal responsibilities of auditors and chief executives and the involvement in the formulation of those duties by the Securities and Exchange Commission ("SEC") and the American Institute of Certified Public Accountants ("AICPA"). Amici Curiae request leave to file this brief because (1) they believe the court will be assisted by their experienced, informed and independent views, and (2) private securities class actions are an essential supplement to SEC actions in enforcing the antifraud provisions of the Securities Acts. They provide some measure of protection to the nearly one hundred million Americans who directly or indirectly own shares of stock. Amicus Curiae have read and are familiar with the briefs filed by the parties and other amicus curiae and do not believe the views expressed in this brief have been presented to the Court so far.

Amici urge the Court to affirm the judgment below. The Court should reject Petitioners' attempt to carve out an exception to the established rules on burden of proof and standards for motions to dismiss in order to provide a near automatic pleading escape route to corporate executives, directors and auditors sued for fraud.

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[1] The parties in this case have advised the Clerk of the Court by letters dated February 5 and February 6, 2007 that each party consents to the filing of all Amici Curiae briefs. None of the counsel for the parties or the parties authored this brief in whole or in part. The brief was wholly authored by Amici, and no person or entity other than Amici have made a monetary contribution to the preparation or submission of this brief.

SUMMARY OF ARGUMENT

The Public Company Securities Class Action Reform Act of 1995 ("PSLRA") was not designed to cripple nonabusive private securities actions for fraud. It did not change the established preponderance of evidence standard by which a trial judge determines at the pleading, summary judgment and trial stages if a plaintiff has presented a genuine issue of fact for trial by jury. The PSLRA requirement is that a plaintiff shall "with respect to each alleged specified fraudulent and material act or omission alleged to violate this Chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." This requirement does not permit the dismissal of a complaint which alleges such facts with particularity on the basis that it also hypothetically raises facts indicating a "substantial possibility" or "equal likelihood" of the contrary.

The court of appeals correctly determined (1) the complaint here alleged with particularity facts on which plaintiffs' belief had been formed that material fraudulent representations had been made and gave rise to a strong inference of Tellabs' chief executive officer's scienter, and (2) a reasonable jury could determine that each of the alleged fraudulent material representations was made with scienter. Contrary inferences hypothesized by Petitioner and their amici do not extinguish those strong inferences, and certainly do not neuter them to preclude, as a matter of law, a reasonable jury accepting them as establishing the requisite scienter.

ARGUMENT

I. THE PSLRA DID NOT CHANGE ESTABLISHED JUDICIAL PROCEDURES ABOUT THE BURDEN OF PROOF.

In response to huge financial frauds involving chief executives, auditors and financial services firms, Congress passed the Sarbanes Oxley Act ("SOX") (116 Stat. 745) by a vote of 99-0 in the Senate and 423-3 in the House of Representatives. When President Bush signed the Bill into law on June 30, 2002 he announced that "The era of low standards and false profits is over." In order to deter and prevent fraud and assist shareholders against its effects, SOX added numerous features to the Securities Acts to increase the duties owed by auditors, executives and directors. It also created the Public Company Accounting Oversight Board, whose powers include the establishment or adoption of auditing standards. (15 U.S.C. §§ 72117219, 72317234, and 72417246.) It did not indicate any intent to lessen the rights of shareholders and other private parties to bring actions in federal court against those who defrauded them, or to change the Federal Rules of Civil Procedure or the courts' general application of the plaintiff's burden of proof.

This case concerns the requirements of the PSLRA to prevent abusive lawsuits with sham claims of fraud. (15 U.S.C. § 78u4(b)(1) and (2).) The Act was not intended to create, as the proceedings in this case have, a five year obstacle course for plaintiffs that present a prima facie case of fraud. Subsection (1) requires that the complaint specify the misleading statements and their materiality, and if it is filed on information and belief "state with particularity all facts on which that belief is formed." Subsection (2) provides that:

> "In any private action arising under this chapter in which the plaintiff may recover money damages

> only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each alleged specified fraudulent and material act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."

Subsection (2) refers to "proof" but does *not* purport to alter the burden of proof in any way. The burden of plaintiffs on defendant's motion to dismiss a private securities class action cannot exceed the burden a plaintiff has on a motion by a defendant for summary judgment, or at trial. Those rules were clear before the PSLRA. The Court held in *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983), that the existence of the implied right of action under section 10 b and Rule 10 b-5, "is simply beyond peradventure," (*id.* at 380), and confirmed that the burden of proof at *trial* in a private securities class action under § 10 b of the 1934 Act was "by a preponderance of the evidence" and not by "clear and convincing evidence." (*id.* at 388-390.) The interests of plaintiffs in securities lawsuits are "significant" because "[d]efrauded investors are among the very individuals Congress sought to protect in the securities laws." (*id.* at 390.) Congress did not purport to change that burden in the PSLRA.

In *Matsushita Elec. Ind. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986) this Court held that a plaintiff need only establish a "genuine issue of material fact" to resist a motion for summary judgment. Although the Court concluded that the claim was economically implausible under antitrust concepts, it held, that even then, evidence could still be admitted though it "must 'tend to exclude the possibility' that petitioners underpriced respondents to compete for business rather than to implement an economically senseless

conspiracy." There is nothing "economically senseless" about executives falsely representing sales to be "strong" when they are weak, or in shipping product that was not ordered. They are typical signposts of fraud by CEOs. Directly applicable is the 1987 Report of the "National Commission on Fraudulent Financial Reporting," known as the Treadway Commission, after its Chairman James C. Treadway, a former SEC Commissioner.[2] It emphasizes, like the present case, that

> "In a large majority of cases ... the company's top management, such as the CEO, the President, and the CFO were the perpetrators ... [w]hile the perpetrators of fraudulent financial reporting use many different means, the effect of their actions is almost always to inflate or 'smooth' earnings or overstate the company's assets ... [it] usually does not begin with an overt intentional act ... In many cases ... [it] ... is the culmination of a series of acts designed to respond to operational difficulties" (*id.* at 24)

"As the pressure mounts, he [the CEO] compounds the situation by delaying the recognition of sales returns, instructing sales representatives to make the sales 'stick'." Finally, "he commits a fraudulent act by recognizing revenue from inventory shipped to a customer without authorization or from inventory shipped to a public warehouse." (*id.* at 24-25) That description virtually mirrors Notebaert's conduct.

In *Eastman Kodak Co. v. Technical Service Inc.*, 504 U.S. 451, 471-474 (1992), the Court held that "Matsushita

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[2] The Commission was appointed by the American Institute of Certified Public Accountants, the American Accounting Association, the Financial Executives Institution, the Institute of Internal Auditors and the National Association of Accountants. The Treadway Commission Report is available from the AICPA at www.cpa2.biz.com.

demands only that the nonmoving party's inference be reasonable in order to reach the jury .. ." (*id.* at 468); and that, in the case before it, *Kodak* failed to demonstrate that respondent's inference of market power was unreasonable. (*Id.* at 477.) "One Lesson of *Kodak*, which perhaps should have been apparent all along, is that summary judgment based on implausibility of the opponent's claim will rarely succeed." Schwarzer and Hirsch, SUMMARY JUDGMENT AFTER EASTMAN KODAK, 45 Hast.L.J. 1, 67, 10 (1993).

In *Anderson v. Liberty Lobby*, 477 U.S. 242 (1986), this Court explained the burden on a movant for summary judgment as follows: A "summary judgment will not lie if the dispute about a material fact is 'genuine' that is, if the evidence is such that a reasonable jury could return a verdict for the nonmoving party" (*id.* at 249). At the summary judgment stage, the judge's function is not "to weigh the evidence and determine the truth of the matter but to determine whether there is a genuine issue of fact" (*id.* at 249). The standard for a grant of summary judgment is the same as the standard for a directed verdict: "If reasonable minds could differ as to the import of the evidence, however, a directed verdict should not be directed," (*id.* at 249-250). A "summary judgment should be refused if the nonmoving party has not had the opportunity to discover information essential to his opposition to the motion" and FRCP 56(f) requires that he be given the opportunity to discover it (*id.* fn. 5 at 251).

In *Celotex Corp. v. Cartrett* 477 U.S. 317 (1986), this Court held that a moving party could prevail on summary judgment by pointing to the absence of any factual support for an essential element of the claim. On remand, the court of appeal held that a single letter supplied sufficient evidence of that essential element (knowledge of the deceased employee's exposure to Firebox fireproofing) and that

summary judgment should be denied. *Cartrett v. Johns Manville Sales Corp.*, 826 F.2d 33, 37-38 (D.C. Cir. 1987).

Nonabusive private securities class actions are a major deterrent to fraud. They are generally the only practical means of even partial compensation for the victims of fraud. Less than five years after the "era of low standards and false profits" was declared to be "over," Petitioner, the SEC, AICPA and other amici curiae are here attempting a virtual abolition of such actions. They would convert the PSLRA into a barrier against nonabusive lawsuits by allowing defendant executives, auditors and others to use an "any excuse will do" argument as a basis to dismiss claims which state, as this complaint does, particulars of fraudulent and material misrepresentations and strong inferences of fraud from which a reasonable jury could determine the scienter (intent or recklessness) required for fraud.

The SEC, an agency charged with the responsibility of protecting investors, proposes a position which would preclude many meritorious shareholder actions against those who have defrauded them. The SEC urges:

> "When the facts alleged in the complaint give rise to a substantial possibility that the defendant acted without scienter, the necessary 'strong inference of scienter will be lacking, because there will be an insufficient likelihood that the conclusion that the defendant acted with scienter follows from the facts alleged in the complaint as a whole.' Amicus Curiae Brief for the United States, p. 25."

Petitioners ostensibly propose a lesser standard, which would require dismissal if a defendant could argue that the facts suggest a possibility equal to that urged by plaintiffs. Its proposed application of that standard, however, shows

that it is close to that of the SEC. There is no basis in the text of PSLRA, its legislative history, precedent or common sense for either proposed interpretation. On a motion to dismiss, a plaintiff is entitled to the application of the same standard that applies on a motion for summary judgment and on a motion for a directed verdict. The action may not be dismissed if "a reasonable jury could return a verdict for the nonmoving party." *Anderson, supra,* 477 U.S. at 249. That was precisely the standard applied by the court of appeals.

Congress manifested no intent to impose upon a plaintiff at the pleading stage a greater burden of persuasion than that plaintiff would be required to show in responding to a motion for summary judgment or a motion for directed verdict. The burden proposed by the SEC provides a defendant accused of fraud in a private securities class action with an easier defense at the pleading stage than that of a criminal defendant, who can gain an acquittal only if there is a reasonable doubt of guilt, and at the pleading stage only if there is no plausible reason for the charge.

Subsection (b)(2) of 15 U.S.C. § 78u4 did not purport to alter in any way a plaintiff's burden of proof at any stage: pleadings, summary judgment or trial. A defendant can only avoid having the trier of fact decide the factual issues in a case if a reasonable jury could not find for the plaintiff. The very notion of a judge measuring factual issues in advance of discovery or trial with such precision as to state their equality is illusory, and would force district judges into subjective analysis of the comparative weight of inferences that were not weak. The balance is not mathematical: it is a determination that each side's contention is one which a reasonable jury might make. Even when each side's contentions, or inferences, are equal, that determination must be left to the jury or, if waived, a judge, after trial.

II. PETITIONERS AND THEIR AMICI ARE WRONG IN URGING THAT PLAINTIFFS' COMPLAINT HERE SHOULD BE DISMISSED ON THE HYPOTHESIS THAT PLAINTIFFS FAILED TO CARRY A HIGHER BURDEN THAN IS REQUIRED AT SUMMARY JUDGMENT OR TRIAL.

Petitioners' contentions or inferences are, in fact, far short of any equality with those alleged by plaintiffs. With respect to falsity and materiality, both the district court and the court of appeals held that the complaint pleaded with sufficient particularity that the CEO of Tellabs, "made false and misleading statements in regard to three of the four items of fraud: the TITAN 5500, the TITAN 6500, and the company's past results." (Opinion (hereafter "Op.") p. 22.) The court of appeals determined that the allegations concerning projected revenues also sufficiently alleged false and misleading statements.

As the court of appeals noted, plaintiffs' complaint, based on information from 27 confidential sources, alleged that Tellabs was flooding customers with unordered TITAN 5500 products (Op. p. 14). In late 2000, Verizon, its largest customer cut its orders by 25%. (Op. p. 11). On December 11, 2000, Notebaert, Tellabs' CEO, represented that demand for TITAN 5500 product "is still growing strong," and a Tellabs' Press Release stated that the TITAN 6500 product was available now (Op. p. 13). On January 23, 2001, a Tellabs' Press Release announced record sales in the 4th quarter of 2000, and in January 2000, Verizon cut its orders for the 5500 down to 50%. (Op. pp. 11-12) Tellabs obtained extra warehouse facilities to house returned product (Op. p. 14). On February 14, 2001, CEO Notebaert represented in Tellabs' annual report for 2000, in response to "a frequently asked question whether demand for the

TITAN 5500 product had peaked," that "No, although we introduced the product nearly 10 years ago, it's still going strong." (Op. p. 12) In that same month one of the 27 confidential sources stated that Verizon's chairman told Tellabs to stop providing Verizon, Tellabs' largest customer, with products that Verizon did not request or require. (Op. p. 14)

A Deutsche Bank analyst asked Tellabs' executives on March 8, 2001 "whether Tellabs was experiencing any material weakness." Notebaert replied "We're still seeing that product continues to maintain its growth rate; it's still experiencing strong acceptance." (Op. p. 12) On June 19, 2001 Tellabs reduced projections for the 2nd quarter, which had been projected at $720-$820m, to $500 million. In a conference call on that date, Notebaert informed investors that the reduction was almost entirely because of an enormous reduction in TITAN 5500 sales. (Op. pp. 4-5)

On those facts, the court of appeals held that a strong inference of scienter had been pleaded with respect to each of the four materially false representations as follows:

TITAN 5500: product: Plaintiffs had shown enough for a reasonable person to infer that Notebaert knew that his statements were false. According to another confidential source, "Notebaert stayed on top of the company's financial health through weekly conversations with his fellow executives. Given the significance of the TITAN 5500 and the number of reports suggesting that his statements were false." (Op. pp. 23-24)

TITAN 6500: A former Tellabs sales director said that Notebaert saw weekly sales reports and projection reports, and a former highlevel sales executive reported that Notebaert knew it was not ready for deployment. "We conclude that

the plaintiffs have pleaded sufficient facts to give rise to a strong inference that Notebaert knowingly lied when he informed investors that the 6500 was 'available now'." (Op. p. 25)

2000 Revenue: The plaintiffs alleged facts sufficient to show that Notebaert knew of the channel stuffing. "Indeed, a former senior business manager at Tellabs informed the plaintiffs that Notebaert 'worked directly with Tellabs'[s] sales personnel to effect the channel stuffing" and a highlevel sales executive claimed that Notebaert unquestionably knew of it. (Op . 26)

Projections: "The scienter for the misrepresentations serves as sufficient circumstantial evidence." (Op. p. 26)

Of the four general indications of scienter referred to in *Novak v. Kasaks*, 216 F.3d 300, 311 (2d Cir. 2000) the second, (engaging in deliberately illegal behavior), third (knowledge of facts of access to information suggesting that the public statements were not accurate), and fourth (failure to check information they had the ability to monitor) are applicable. As the court held in *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1187, 1188 (10th Cir. 2003):

> "We emphasize that this process does not involve a 'weighing' of the plaintiff's suggested inference against other inferences. Faced with two seemingly equally strong inferences, one favoring the plaintiff and one favoring the defendant, it is inappropriate for us to make a determination as to which inference will ultimately prevail lest we invade the traditional role of the factfinder."

Ironically, CEO Notebaert's false statements that TITAN 5500 sales were "strong" rather than "weak," illustrates the

real meaning of the statutory phrase. A particular inference is strong if a reasonable jury could find in favor of it; if not, the inference is weak. TITAN 5500 sales were in fact weak. If the CEO did check, he knew his statement was false, and if he did not check before making the statement, he is charged with knowledge that they were weak. In either case, he had the requisite scienter.

Overall, it is a caricature of realty for Petitioners to argue for dismissal of this complaint on the ground that the CEO of Tellabs did not know what he was talking about when he made his false representations. Their contentions, and those of the SEC and other amici, that his claimed lack of knowledge should be given greater credence than the contrary allegations of the complaint supported by 27 confidential informants has no place in the consideration of a motion to dismiss. A personal profit motive is not necessary for scienter. (Op. p. 20) Petitioners know the dates on which Tellabs ordered and received the designated "early 2001" $100,000 Probe Report and manager's reports. If they thought those dates conclusively rebutted any genuine issue concerning their particular relevance to the intent of the CEO, they could have presented those details, and particular discovery about them could have been permitted under 15 U.S.C. § 78u4(3)(B) "to prevent undue prejudice."

Petitioners' speculation that channel stuffing might have been partially due to discounts would not, even if true, detract from the facts that (1) the discounts reflected a weak demand, (2) its largest customer Verizon cut orders by 50%, telling Tellabs it had sent shipments that had not been ordered, and (3) warehouses had to be leased to receive extraordinarily greater quantities of returned products. Petitioners' contentions concerning Tellabs' revising its projections downward from March 7 onward, fail to note that the March and April reductions were trivial in view of the collapse of

the TITAN 5500 market and the unreadiness of the TITAN 6500 market.

The recurring problem of who will guard the guardians requires a brief response to AICPA's brief which is joined by major audit firms who audit over 90% of the financial statements of entities on national exchanges. AICPA is not a reliable source for an objective discussion of the problem of enforcing the duties of auditors to detect and disclose fraud. It has a long history of attempting to evade auditor's duties to detect and disclose fraud, and opposing legal responsibility for failure to perform those duties, notwithstanding the vital importance of those duties to the investing public and the integrity of financial markets. The SEC, In The Matter of McKesson & Robbins, Accounting Series Release No. 19 (1940) left, "until experience should prove to the contrary," the promulgation by AICPA of an auditing standard stating the auditor's duties to detect and disclose fraud. (*Id.* at 11.) AICPA had still failed to promulgate a fraud standard when the court of appeals decided the landmark case of *United States v. Simon*, 425 F.2d. 796 (2d. Cir. 1969) *certiorari denied* 397 U.S. 1006 (1970).

The defendant auditors in *Simon* were prosecuted for conspiracy to willfully falsify or cover up a material fact under 18 U.S.C. § 1001 and 15 U.S.C. § 78ff. The auditors had given a "clean opinion" concerning the financial statements of a corporation they knew to be insolvent. They did so by including as an asset the face value of a promissory note from its President, which they knew he could not pay, and which was mostly secured by his stock in the insolvent corporation. A footnote to the financial statements stated that the note was secured with "marketable securities." The defense, supported by eight expert witnesses who were "leaders of the profession," was that accounting principles

did not require the identification of the securities. (*Id.* at 805.) In affirming their conviction, the court of appeals held that "once fraud had been discovered full disclosure must be the rule." (*Id.* at 807.)

Under the rule proposed by the SEC and AICPA, a defendant could successfully urge dismissal with prejudice of a complaint in a private securities action alleging analogous facts, on the theory that there was a substantial possibility that the required state of mind could not be inferred because an accountant relied on such an accounting principle. Indeed, the executive and the accountant would argue that they conferred together and agreed there was a "substantial possibility" that it would not be fraud. That is not speculation. Professor Donald J. Kirk emphasized the point in explaining why it will be difficult for the accountants to regain trust (Journal of Accountancy On Line Issues, 2005, REGAINING TRUST, SEVEN VOICES FROM THE PROFESSION (http://aicpa.org/pubs/jofa/oct2005/ voices.htm)). In his 45 years of association with the accounting profession:

> "[W]hat disappointed me most were professionals convincing themselves that doing anything other than what was specifically prohibited was fair game .... Cap all that with the years of effort to minimize the professions responsibility for the detection of fraud, and you have some of the reasons why regaining trust will take a gigantic effort ..."[3]

In 1974, in the wake of the Equity Funding and other enormous national financial scandals, AICPA appointed the Commission on Auditor's Responsibilities, known after its

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[3] Donald J. Kirk is a former chairman of the Financial Accounting Standards Board, a recipient of the AICPA's gold medal for distinguished service, and a former partner of Price Waterhouse.

Chairman, Manuel Cohen, formerly Chairman of the SEC. The Cohen Commission's Report, in 1978, related the erosion by AICPA and others of "The straightforward recognition of the detection of fraud as an object of an audit" and the seeming disavowal by the accounting profession of "all but an incidental concern for fraud detection." (AICPA, THE COMMISSION ON AUDITORS' RESPONSIBILITIES: REPORT, CONCLUSIONS, AND RECOMMENDATIONS (New York: AICPA, 1978), 33, 35 (available at the University of Mississippi Library, only to AICPA members.) The result was, as the Treadway Commission reported in 1987, that "a survey of accounting and auditing textbooks indicate[d] that the coverage of fraudulent financial reporting is minimal to nonexistent." (Treadway Commission Report, *supra*, at 108)

It was not until 1989, nearly fifty years after the SEC called on AICPA to promulgate an effective standard of an auditor's duty to detect fraud that it adopted SAS 53. The word "fraud" did not even appear in the title of an auditing standard until SAS 82 (which only became effective in 1998). The current standard, SAS 99, adopted in 2002 is still defective in many respects. As for current performance of those duties, on January 22, 2007, a PCAOB Report, Release No. 2007-001, identified the following continuing deficiencies in the performance of audits by audit firms: *knowledge* of fraud and fraud risks; *adequate responses* to identified fraud risk factors; *expansion* of audit procedures when addressing identified risk factors; *inquiries* of audit committees and management; *evaluation* of the risk of management overriding controls; *deficiencies* of analytical procedures; *documentation* of performance of procedures and other deficiencies.

Petitioners and their amici use selected dictionary definitions of "strong" and "inference" to conflate the phrase "strong inference" with final "conclusions" about the merit

of the case regardless of its context in the pleading stage which frames the issue of the facts regarding the required state of mind. Webster's New 20th Century Dictionary, Unabridged Edition 1975, draws distinctions more apt to the question before the Court. It points out that "Conclusion signifies the final logical result in a process of reasoning. Deduction signifies the bringing or drawing of one thing from another. A conclusion is full and decisive. It ends all further reasoning. *An inference is partial and indecisive; a* conclusion ends all further reasoning." (*id.* at 938) Here the strong inference at the pleading stage is that there is a genuine issue for discovery and further proceedings, and that at this stage of the proceedings a reasonable jury could determine that CEO Notebaert acted with the required state of mind.

A few words will suffice with respect to the amici briefs by the Securities Industry, Joseph Grundfest and others which refer to the costs of "nuisance" filings and "abusive" litigation[4] and recommend diversification of investment as a substitute for actions by defrauded shareholders. In fact, securities class actions have been declining.[5]

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[4] *See, e.g.*, Brief for Amici Curiae Joseph Grundfest, et al pp. 4, 9. They quote Professor Coffee about the "routine filing" of "nonmeritorious" lawsuits (*id.* p.15), but do not note his statement that: "The true 'strike suit nuisance action,' filed only because it was too expensive to defend is, in this author's judgment, a beast like the unicorn, more discussed than directly observed." Coffee, REFORMING THE SECURITIES CLASS ACTION: AN ESSAY ON DETERRENCE AND ITS IMPLEMENTATION, 106 Col. Law. Rev 1534 (2006) at 1536 fn 5.

[5] In 2005, auditors were named in only five cases (3% of all securities class actions), Cornerstone Research study "Securities Class Action Case Filings 2005: A Year in Review" at 12. A later Cornerstone Research study "Securities Class Action Case Filings, 2006 MidYear Assessment" reports that filings "decreased noticeably in the first half of 2006" and that 2006 may reflect the lowest annual (Cont'd)

The Securities Industry's point of view is endorsed in a book by Professors Butler and Ribstein, THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED: HOW TO FIX IT (American Enterprise Institute, 2006) which states, at p. 98, "Shareholders are better off diversified and rationally ignorant." That point of view cannot help but give rise to the impression that those who obtain their remuneration and fees as a result of market actions caused by fraud are indifferent to the damages suffered by shareholders. There is no reason why shareholders who are diversified should not also recover damages inflicted on them by fraud; nor why shareholders who are not diversified, sometimes because their pension plans do not permit it, should be left without remedies. Pleas by the major audit firms and the financial services industry to release them or limit their liabilities for fraud are not appropriately addressed to this Court. Investment markets are not a casino. Fraud destroys their integrity. The enforcement of laws against fraud is vital to society, including the financial sector.

(Cont'd)

filings since 1996. The lower filings in 2005 and 2006 were related, in part to corporate governance improvements since Sarbanes Oxley (*id.* at 2.)

Even more decisive in the real world is the report of the vice president of the Insurance Information Institute in New York that the costs of directors' and officers' liability insurance have plummeted in the past two years, falling almost 40% in 2005, an additional 10% in 2006, and would probably decline again in 2007. The vice president said that the "changes in corporate governance practices and transparency to shareholders as a result of the Sarbanes-Oxley Act have likely contributed to the decline in D&O rates," Gretchen Morgenson, FAIR GAME. MEMO TO SHAREHOLDERS: SHUT UP, *N.Y. Times*, February 11, 2007, at A1.

CONCLUSION

For the foregoing reasons, the judgment below should be affirmed and this Court should confirm the continued application to securities lawsuits of established Federal rules on burden of proof and terminal motions. Effective legal remedies are the only true deterrent to the abuse of corporate power.

Respectfully submitted,

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In The
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TELLABS, INCORPORATED AND
RICHARD C. NOTEBAERT,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *ET AL.*,

Respondents.

**On Writ Of Certiorari To The
United States Court Of Appeals
For The Seventh Circuit**

BRIEF FOR *AMICI CURIAE* NATIONAL CONFERENCE ON PUBLIC EMPLOYEE RETIREMENT SYSTEMS AND NATIONAL ASSOCIATION OF SHAREHOLDER AND CONSUMER ATTORNEYS IN SUPPORT OF RESPONDENTS

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I. INTERESTS OF THE *AMICI CURIAE*[1]

The National Conference on Public Employee Retirement Systems ("NCPERS") is the largest national, nonprofit public pension trade association, with a membership that includes over 500 pension funds representing nearly $3 trillion in assets. Since 1941, NCPERS has worked to protect the pensions of public employees. Because of NCPERS' interest in preserving retirement benefits for public employees, it is very concerned about fraudulent practices in the securities industry and the nation's capital markets. NCPERS recognizes the need to combat securities fraud and restrain corporate excess, and appreciates the role of private securities actions in providing a means to deter corporate wrongdoing and compensate victims of securities fraud.

The National Association of Shareholder and Consumer Attorneys ("NASCAT") is a nonprofit membership organization founded in 1988. NASCAT's member law firms represent investors (both institutions and individuals) in securities fraud and shareholder derivative cases throughout the United States. NASCAT and its members are devoted to representing victims of corporate abuse, fraudulent schemes, and so-called "white collar" criminal activity in cases that have the potential for advancing the state of the law, educating the public, modifying corporate behavior, and improving access to justice and compensation for the wrongs inflicted upon victims. NASCAT advocates the principled interpretation and application of the federal securities laws – including the Securities Act of 1933 (the "1933 Act"), the Securities Exchange Act of 1934 (the "1934 Act"), and the Private Securities Litigation Reform Act of 1995 (the "PSLRA") – to protect investors from manipulative, deceptive and fraudulent practices,

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[1] In accordance with Rule 37.6, counsel for NCPERS and NASCAT represent that they authored this brief in whole and that no person other than the *amici curiae*, their members or their counsel made a monetary contribution to its preparation or submission. Petitioners and Respondents have consented to the filing of this brief.

and to ensure that the nation's capital markets operate fairly and efficiently. NASCAT has previously filed *amicus curiae* briefs in this Court in cases involving the construction and application of the federal securities laws.[2]

II. INTRODUCTION

This case concerns the "strong inference" requirement for pleading scienter imposed on private securities fraud complaints seeking to recover damages under Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission ("SEC"). For the reasons stated above, NCPERS and NASCAT are qualified to advise this Court, as *amici curiae*, of the meaning and import of Section 21D(b)(2) of the PSLRA, which imposed the "strong inference" requirement for pleading the scienter element of Section 10(b)/Rule 10b-5 claims, as applied by the Courts of Appeals since the PSLRA's passage. NCPERS and NASCAT believe that when this Court examines the relevant statutory language and the well-settled jurisprudence concerning the interpretation of Federal Rule of Civil Procedure 9(b), which Section 21D(b)(2) was intended to supplement as to private securities fraud complaints, it will agree that the Seventh Circuit's holding was correct and that Section 21D(b)(2) does ***not*** require the weighing of competing inferences. Further, NCPERS and NASCAT believe that the Seventh Circuit's opinion is consistent with the important public policies underlying private enforcement of the federal securities laws, and that affirming the decision of the court below will further the goals of deterring securities fraud, engendering public trust in the capital markets, and protecting victims

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[2] *See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 126 S. Ct. 1503 (2006) (NASCAT-AARP); *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005) (AARP-NASCAT-Consumer Federation of America); *S.E.C. v. Zandford*, 535 U.S. 813 (2002) (AARP-NASCAT); *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) (NASCAT); *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286 (1993) (NASCAT).

of investment fraud, so that they may obtain adequate recovery for their losses.

NCPERS and NASCAT submit that any reasoned analysis of Section 21D(b)(2)'s "strong inference" requirement cannot be viewed in isolation but, rather, must take into account the remarkable instances of breaches of fiduciary duty, failed audits, and corporate scandals that have infected this nation's capital markets almost from the date of passage of the PSLRA. Financial scandals at Enron, WorldCom, Tyco International, Global Crossing, Adelphia Communications, and others have cost shareholders staggering amounts of money. The more recent scandals regarding "market timing" of mutual funds and the back-dating of options to swell the earnings of already well-compensated corporate executives have done nothing to shore up the confidence of the average shareholder or mutual fund investor but, rather, have undermined the faith of investors in our capital markets.

When Congress enacted the PSLRA, it recognized that private securities actions are "an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action" and that such litigation "promote[s] public and global confidence in our capital markets and help[s] to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers, and others properly perform their jobs." H.R. CONF. REP. NO. 104-369 ("H.R. CONF. REP."), at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 731. This Court has likewise acknowledged on numerous occasions the salutary purposes of the private right of action for securities fraud as an augment to the SEC's regulatory enforcement activities. *See, e.g., Dura*, 544 U.S. at 345 (observing that "the availability of private securities fraud actions" acts to deter fraud and thereby assist in maintaining "public confidence in the [securities] marketplace"); *Randall v. Loftsgaarden*, 478 U.S. 647, 664 (1986) (cautioning against any impairment of "the deterrent value of private rights of action" under the securities laws); *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (emphasizing that "implied private actions provide

'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to [SEC] action'") (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)). *See also Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (the private right of action "constitutes an essential tool for enforcement of the 1934 Act's requirements") (citations omitted); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 (1983) (observing that "the interests of plaintiffs in [private securities fraud cases] are significant [and since] [d]efrauded investors are among the very individuals Congress sought to protect in the securities laws[,] [i]f they prove that it is more likely than not that they were defrauded, they should recover.").

Petitioners and their *amici* ignore these important public policies, argue as if the restrictions imposed by the PSLRA and significant amendments to the Federal Rules of Civil Procedure have not had a profound effect on how private securities actions are litigated, and ask this Court to impose yet another procedural hurdle – this one nearly insurmountable – on the ability of private investors to deter corporate wrongdoing and recoup some of their losses. This Court should decline the invitation and should affirm and endorse the decision of the court below.

III. SUMMARY OF ARGUMENT

The question presented by this appeal is narrow and, as Petitioners and their *amici* consciously choose to ignore, ***only*** arises when a securities fraud complaint has satisfied the heightened pleading requirement for scienter imposed by Section 21D(b)(2), added to the 1934 Act by the PSLRA, and codified at 15 U.S.C. § 78u-4(b)(2). As recognized by the Seventh Circuit, a court need not engage in an exercise of counterbalancing "strong inferences" of scienter with so-called "innocent inferences" because the mandate of Section 21D(b)(2) is satisfied once a "strong inference" of scienter has been established. For a court to search the face of the pleadings to identify supposed "innocent inferences" of scienter to offset alleged "strong inferences" exceeds the PSLRA's heightened pleading

requirements and contravenes a securities fraud plaintiff's Seventh Amendment rights. *See Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602 (7th Cir. 2006) ("Faced with two seemingly equally strong inferences, one favoring the plaintiff and one favoring the defendant, it is inappropriate for us to make a determination as to which inference will ultimately prevail, lest we invade the traditional role of the fact finder") (quoting *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1188 (10th Cir. 2003)).

The stated purpose of Section 21D(b)(2) is to "establish uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits." Although the imposition of "stringent pleading requirements" has reduced the number of securities fraud suits being filed, the goal of uniformity has yet to be achieved. Rather, the PSLRA pleading requirements have spawned two significant splits among the Courts of Appeals (presenting yet another similarity with Rule 9(d), which Section 21D(b)(2) was supposed to replace): the first over the manner in which allegations sufficient to give rise to a "strong inference" of scienter may be pleaded, and the second – directly implicated in this appeal – regarding whether a plaintiff must be afforded the traditional deference on a Rule 12(b)(6) motion to dismiss once a "strong inference" of scienter has been adequately alleged.

Petitioners' arguments disregard the well-established judicial principle that all pleadings must be construed in a light most favorable to plaintiffs, and this Court's directive that "a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). Further, as the lower federal courts have reaffirmed in the securities fraud context, all reasonable inferences that can be drawn from the face of the pleadings should be drawn in plaintiff's favor. *In re Stone & Webster, Inc., Sec. Litig.*, 414 F.3d 187, 193 n.2 (1st Cir. 2005) ("We are skeptical of this reading of the Complaint, especially given the obligation to construe the Complaint in the light most favorable to plaintiffs."); *No. 84*

Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp., 320 F.3d 920, 946 (9th Cir.), *cert. denied*, 540 U.S. 966 (2003) ("In this era of corporate scandal, when insiders manipulate the market with the complicity of lawyers and accountants, we are cautious not to raise the bar of the PSLRA any higher than that which is required under its mandates. The District Court's failure to accept Plaintiffs' allegations as true and construe them in the light most favorable to Plaintiffs does just that"); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (*en banc*), *cert. dismissed*, 536 U.S. 935 (2002) ("Our willingness to draw inferences in favor of the plaintiff remains unchanged by the PSLRA ... [which] would hardly serve its purpose to protect investors and to maintain confidence in the securities markets ... were it to become a choke-point for meritorious claims") (citations and internal quotations omitted).

Any consideration of possible "innocent inferences" at the pleading stage will inevitably result in defendants raising even the most tenuous but supposed innocent inferences and thereby turn the pleading stage into a mini-trial on the merits of the allegations, when plaintiffs have not been afforded the benefit of any formal discovery. Defendants will seize on the established principle that, when ruling on a motion to dismiss, a trial court may properly consider, *inter alia*, documents referenced in a complaint though not attached, so long as neither party questions the authenticity of those documents, documents that are integral to a plaintiff's claim but not explicitly incorporated in the complaint, or matters that are properly the subject of judicial notice. Unlike any other area of litigation, securities fraud defendants will be in the extraordinary position to self-select from their library of documents support for supposed "innocent inferences" that can be drawn from the pleadings, at a stage when plaintiffs are prohibited from serving a single discovery request.

The PSLRA's heightened pleading requirement is satisfied when the allegations in a securities fraud complaint support a strong inference of scienter. To the extent

a defendant is able to establish a competing inference for purposes of a motion to dismiss, that inference should ***not*** be considered by a district court at that time but, rather, should be the subject of discovery and, possibly, a motion for summary judgment. Such an approach fulfills the mandate of the PSLRA by permitting meritorious claims to proceed to discovery, and keeps inviolate a party's constitutional right to a trial by jury. Contrary to the rhetoric of Petitioners and their *amici*, the stated goal of the PSLRA is to avoid vexatious, lawyer-driven litigation. The heightened pleading requirement is only one arrow in a corporate defendant's quiver. The goal to eradicate lawyer-driven litigation is being aptly fulfilled through the PSLRA's "lead plaintiff" provisions, which encourage large and sophisticated institutional investors to control the litigation – not class action lawyers. The PSLRA's discovery stay also prevents so-called "fishing expeditions" by staying discovery until after the district court first determines that the applicable pleading requirements have been met. As a result, since 1996 the number of private securities actions filed have steadily declined and the percentage of securities fraud complaints dismissed on a Rule 12(b)(6) motion has increased.

IV. ARGUMENT

A. THE PSLRA PLEADING REQUIRMENTS WERE INTENDED TO DISPOSE OF FRIVOLOUS ACTIONS, NOT MERITORIOUS CLAIMS.

The PSLRA's "required state of mind" requirement for complaints alleging securities fraud provides that:

> In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. § 78u-4(b)(2).[3] This provision is one of two pleading "requirements" imposed by the PSLRA that, if not met, mandate the trial court's dismissal of the complaint. 15 U.S.C. § 78u-4(b)(3)(A).

The stated purpose for Section 21D(b)(2) was "to curtail the filing of meritless lawsuits." H.R. CONF. REP., at 41; S. REP. NO. 104-98 ("S. REP."), at 15 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 694 (same). In this respect, Section 21D(b)(2) was similar to Rule 9(b)[4] and, at the time the PSLRA was enacted, the standard for compliance with Rule 9(b) used by courts in the Second Circuit was considered the most rigorous. *See* S. REP., at 15 (referring to Second Circuit precedent as "the most stringent pleading standard"); *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 407 (5th Cir. 2001) (same).

Developed to, *inter alia*, "minimize the number of strike suits," *see Segal v. Gordon*, 467 F.2d 602, 607 (2d Cir. 1972), Second Circuit caselaw recognized that, pursuant to Rule 9(b), "malice, intent, knowledge, and other condition of mind" could be "averred generally" because "it would be unworkable and unfair to require great specificity in pleading scienter." *See Stern v. Leucadia Nat'l Corp.*, 844 F.2d 997, 1004 (2d Cir.), *cert. denied*, 488 U.S. 852 (1988) ("[A] plaintiff realistically cannot be expected to plead a defendant's actual state of mind") (citation omitted). Nevertheless, it was required that the "circumstances must be pleaded that provide a factual foundation for otherwise conclusory allegations of scienter." *Id.* (citations

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[3] "Securities fraud" refers to a cause of action based on Section 10(b) of the 1934 Act, 15 U.S.C. § 78j, and/or SEC Rule 10b-5, 17 C.F.R. § 240.10b-5. The "required state of mind" for an action for securities fraud is "scienter." *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (holding that no "private cause of action for damages will lie under § 10(b) and Rule 10b-5 in the absence of 'scienter' – intent to deceive, manipulate, or defraud").

[4] Rule 9(b) provides that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally." FED. R. CIV. PROC. 9(b).

omitted). *See Ross v. Bolton*, 904 F.2d 819, 823 (2d Cir. 1990) (explaining that "[w]hen fraud is asserted, the general rule [that pleadings are to be construed in the light most favorable to the pleader and accepted as true] is simply applied in light of Rule 9(b)'s particularity requirements"). Accordingly, plaintiffs alleging fraud-based claims were required to "allege facts that give rise to a strong inference of fraudulent intent." *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994) (citations omitted).[5] In order to meet this "strong inference" threshold, the Second Circuit adopted two separate approaches: requiring factual allegations that established both "a motive to commit fraud and an opportunity to do so" or alternatively, "to allege facts constituting circumstantial evidence of either reckless or conscious behavior." *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268-269 (2d Cir. 1993), *cert. denied sub. nom.*, 511 U.S. 1017 (1994).

The Second Circuit's Rule 9(b) pleading requirements sought to balance two competing interests – that of deterring and remedying fraud in the capital markets, with the accompanying recognition "that victims of fraud often are unable to detail their allegations until they have had some opportunity to conduct discovery," *In re Time Warner*, 9

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[5] Some Courts of Appeals announced similar constructions of Rule 9(b). *See, e.g., Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994) ("To plead scienter adequately, a plaintiff must set forth specific facts that support an inference of fraud") (citations omitted); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 878 (1st Cir. 1991) (plaintiff must state "factual allegations that would support a reasonable inference that adverse circumstances existed at the time of the offering, and were known and deliberately or recklessly disregarded by defendants"); *Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1127 (7th Cir. 1990), *cert. denied*, 499 U.S. 923 (1991) (complaint alleging fraud "must still afford a basis for believing that plaintiffs could prove scienter"). Other Courts of Appeals, most notably the Ninth Circuit, took a more lenient approach to allegations of fraudulent conduct. *See In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1545-47 (9th Cir. 1994) (*en banc*) (rejecting the Second Circuit's construction and concluding "that plaintiffs may aver scienter generally, just as the rule states – that is, simply by saying that scienter existed").

F.3d at 263, versus the interest in "deterring the use of the litigation process as a device for extracting undeserved settlements as the price of avoiding the extensive discovery costs that frequently ensue once a complaint survives dismissal." *Id.* Section 21D(b)(2) sought to balance similar interests. *See* H.R. CONF. REP. at 31 ("Private securities litigation" assists the recovery of defrauded investors' losses and "help[s] to deter wrongdoing," but "abuse of the discovery process . . . impose[s] costs so burdensome that it is often economical for the [defendant] to settle"). But while Rule 9(b) was tempered by the "short and plain" pleading requirement of Rule 8(a)(2),[6] and arguably favored a plaintiff alleging securities fraud, Section 21D(b)(2), when considered together with Section 21D(b)(3)'s discovery stay "during the pendency of any motion to dismiss," 15 U.S.C. § 78u-4(b)(3), decisively tilts the balance in favor of corporate defendants. *See Dabit*, 126 S. Ct. at 1511 ("The effort to deter or at least quickly dispose of those suits whose nuisance value outweighs their merits placed special burdens on plaintiffs seeking to bring federal securities fraud class actions").

1. The PSLRA Does Not Preclude Consideration Of Allegations That Give Rise To A Strong Inference Of Scienter.

Construction of a statute begins with the language of the statute itself. *Barnhart v. Sigmon Coal Co., Inc.*, 534 U.S. 438, 450 (2002); *Ernst*, 425 U.S. at 197. If the language of the statute is plain and its meaning sufficiently clear, there is no need to resort to legislative history.

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[6] Rule 8(a) provides that "[a] pleading which sets forth a claim for relief . . . shall contain . . . (2) a short and plain statement of the claim showing that the pleader is entitled to relief . . . " FED. R. CIV. PROC. 8(a). "This simplified notice pleading standard relies on liberal discovery rules and summary judgment motions to define disputed facts and issues and to dispose of unmeritorious claims." *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 512 (2002).

Connecticut Nat'l Bank v. Germain, 503 U.S. 249, 254 (1992).[7]

Here, Section 21D(b)(2) requires a securities fraud complaint to set forth specific "facts giving rise to a strong inference" of scienter. 15 U.S.C. § 78u-4(b)(2). However, this provision "neither mandated nor prohibited *any* particular method of establishing a strong inference of scienter." *Nathenson*, 267 F.3d at 411 (citing *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195 (1st Cir. 1999)) (emphasis in original). Accordingly, a majority of Courts of Appeals have concluded that the PSLRA does *not* prevent the consideration of any allegations that give rise to a strong inference of scienter, including those allegations recognized by pre-PSLRA Second Circuit precedent that infer both a motive to commit fraud and an opportunity to do so. *See, e.g., In re Advanta Corp.*, 180 F.3d at 534 (the "use of the Second Circuit's language compels the conclusion that the [PSLRA] establishes a pleading standard approximately equal in stringency to that of the Second Circuit"); *Novak v. Kasaks*, 216 F.3d 300, 310 (2d Cir.), *cert. denied*, 531 U.S. 1012 (2000) (concluding "that the PSLRA effectively raised the nationwide pleading standard to that previously existing in this circuit and no higher," but that "Congress's failure to include language

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[7] Even if Section 21D(b)(2) were to be deemed ambiguous, the legislative history would be of little assistance. It has been routinely criticized as "conflicting and inconclusive," *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003), "ambiguous," *In re Comshare Inc. Sec. Litig.*, 183 F.3d 542, 552 n.10 (6th Cir. 1999), and as reflecting "conflicting expressions of legislative intent." *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 533 (3d Cir. 1999). Accordingly, where the legislative history of a statute is contradictory and unenlightening, this Court should hesitate to rely on it. *See, e.g., Exxon Mobil Corp. v. Allapattah Services, Inc.*, 545 U.S. 546, 568 (2005) (observing that "legislative history is itself often murky, ambiguous, and contradictory [and that] [j]udicial investigation of legislative history has a tendency to become . . . an exercise in 'looking over a crowd and picking out your friends' ") (citation omitted); *see also Ratzlaf v. United States*, 510 U.S. 135, 147-48 (1994) (court should not "resort to legislative history to cloud a statutory text that is clear").

about motive and opportunity suggests that we need not be wedded to these concepts in articulating the prevailing standard"); *In re K-Tel Int'l, Inc. Sec. Litig.*, 300 F.3d 881, 894 (8th Cir. 2002) (allegations of "unusual or heightened motive" may be "particularly important to establishing scienter").[8] Thus, if Section 21D(b)(2) at least equals the pleading level formerly imposed only in the Second Circuit, *see, e.g.*, *Nathenson*, 267 F.3d at 412, all factual allegations of a complaint that may give rise to a strong inference of scienter should be considered by a district court on a motion to dismiss.[9]

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[8] The Courts of Appeals seemingly disagree about whether allegations of motive and opportunity, standing alone, can support a strong inference of scienter. The Second and Third Circuits have held that such allegations may be sufficient, *see, e.g.*, *Novak*, 216 F.3d at 311; *In re Advanta Corp.*, 180 F.3d at 534-535; *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 537-538 (2d Cir. 1999), the Ninth Circuit has categorically rejected them, *see In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999), and the remaining Circuits have held that such allegations may be independently insufficient, but should be considered along with any other allegations (*i.e.*, among the "totality of facts and pleadings") supporting scienter. *See, e.g.*, *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1285-1287 (11th Cir. 1999); *Greebel*, 194 F.3d at 188; *Helwig*, 251 F.3d at 550; *Nathenson*, 267 F.3d at 410-411; *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 660 (8th Cir. 2001); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1261-1262 (10th Cir. 2001); *Ottmann*, 353 F.3d at 345-346. The Ninth Circuit initially concluded that Section 21D(b)(2) required "deliberate recklessness," *see In re Silicon Graphics*, 183 F.3d at 974, which other courts have described as "an attempt to import into the law a new and uncertain super-recklessness." *Bryant*, 187 F.3d at 1284 n.21. However, commentators have suggested that, in application, the *Silicon Graphics*' "deliberate recklessness" is more akin to the recklessness standard used in other Circuits. *See* Ann Morales Olazabal, *The Search For "Middle Ground": Towards A Harmonized Interpretation Of The Private Securities Litigation Reform Act's New Pleading Standard*, 6 STAN. J.L. BUS. & FIN. 153, 163 (2001) ("[T]here is no reason to believe that the Ninth Circuit's 'deliberate recklessness' is any different from [standards of recklessness required in other Circuits] . . . ").

[9] It is noteworthy that the *amicus curiae* brief filed in this appeal by the United States, through the Department of Justice and the SEC (collectively, the "SEC *Amicus* Br.") departs markedly from over 40

(Continued on following page)

2. The Text Of Section 21D(b)(2) Does Not Alter The Determination Of The Sufficiency Of A Complaint's Allegations On A Motion To Dismiss.

The function of a district court on a motion to dismiss "is not to weigh potential evidence . . . , but to assess whether the plaintiff's complaint alone is legally sufficient . . . " *Pirraglia*, 339 F.3d at 1187 (citation and internal quotations omitted). This is a well-recognized precept. *See, e.g., Global Network Comm., Inc. v. City of New York*, 458 F.3d 150, 155 (2d Cir. 2006) (Rule 12(b)(6) "assesses the legal feasibility of the complaint, but does not weigh the evidence that might be offered to support it"); *Westside Mothers v. Olszewski*, 454 F.3d 532, 537-538 (6th Cir. 2006)

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years of SEC arguments supporting full protection of investors. *See, e.g., Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 732 (1975) (noting 1957 and 1959 legislative attempts by the SEC to expand the "in connection with" language of Section 10(b) to encompass "*any attempt* to purchase or sell any security") (emphasis added); *Ernst*, 425 U.S. at 197-198 & n.18 (noting SEC's argument that language of Section 10(b) is not limited to "knowing or intentional practices," but may include liability for negligent violations of Rule 10b-5). For example, in an *amicus* brief filed in connection with *Greebel*, 194 F.3d 185, the SEC unequivocally advocated that the PSLRA "adopts the Second Circuit standard for pleading scienter in a private action," *see* SEC *amicus* br., 1999 WL 33911562 (1st Cir. May, 1999), at *1, and stated that the SEC had taken the same position in *amicus curiae* briefs filed in five other pending appeals, including the Second, Sixth, and Eleventh Circuits. *Id.*, at *1 n.1. In the *amicus curiae* brief filed in connection with *In re K-Tel Int'l*, 300 F.3d 881, the SEC argued for a presumption that Congress intended to adopt the Second Circuit's "strong inference" standard. *See* SEC *amicus* br., 2000 WL 35483737, at *12 (8th Cir. Nov. 15, 2000). These arguments stand in stark contrast to the position the SEC takes here. For instance, the SEC argues in this appeal that Congress merely "built upon," rather than adopted, the Second Circuit's precedent, and that where competing inferences are presented, the district court should weigh them and absolve a corporate defendant if "there is a substantial possibility that the defendant acted without scienter." *See* SEC *Amicus* Br. at 18, 24-25. Given the radical departure from previous positions, it is questionable whether the SEC's position should be afforded its customary deference.

(function on a motion to dismiss "is not to weigh the evidence or assess the credibility of witnesses, . . . but rather to examine the complaint and determine whether the plaintiff has pleaded a cognizable claim, . . . "); *see generally*, 5B Charles Alan Wright & Arthur Miller, FEDERAL PRACTICE AND PROCEDURE: CIVIL § 1356 (3d ed. 2004) (a motion to dismiss "is not a procedure for resolving a contest between the parties about the facts or the substantive merits of the plaintiff's case"). Nevertheless, some Courts of Appeals have seemingly determined that weighing of inferences is appropriate at the motion to dismiss stage. *See Helwig*, 251 F.3d at 553 (on motion to dismiss securities complaint, "plaintiffs are entitled only to the most plausible of competing inferences"); *cf.*, *Gompper v. VISX, Inc.*, 298 F.3d 893, 897 (9th Cir. 2002) ("When determining whether plaintiffs have shown a strong inference of scienter, the court must consider *all* reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs") (emphasis in original). *See generally*, Rick M. Simmons, *Reconciling Pleading Standards Under Pirraglia: The Private Litigation Reform Act v. Federal Rule of Civil Procedure 12(b)(6)*, 81 DENV. U.L. REV. 665, 673-678 (2004) (survey of the differing approaches of Courts of Appeals to weighing competing inferences in securities fraud complaints).

Going beyond even the weighing of competing inferences, Petitioners argue that a "strong inference" of scienter only exists where "the facts cogently demonstrate a promising and substantial claim on the merits that meaningfully tends to exclude alternative innocent explanations." Pet. Br. at 25-26, 34 n.15. Not surprisingly, Petitioners do not rely on ***any*** PSLRA decisions for such a sweeping proposition but, rather, cite *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986). Pet. Br. at 26 n.13, 30. However, Petitioners' attempts to equate a summary judgment decision in an antitrust action, issued after years of discovery, with the manner in which a securities fraud complaint should be evaluated on a motion to dismiss, are without merit. First and most

obvious, a summary judgment standard has little application to a motion to dismiss, particularly where, as here, discovery is largely prohibited. *See, e.g., Global Network*, 458 F.3d at 155 ("The streamlined testing of the substantive merits, on the other hand, is more appropriately reserved for the summary judgment procedure, governed by Rule 56, where both parties may 'conduct appropriate discovery and submit the additional supporting material contemplated by' that rule.") (citation omitted). Second, although *Matsushita* warned of the cost that "mistaken inferences" may have on legitimate competition, *id.*, 475 U.S. at 594, no such concern faces Petitioners and their *amici*. Pursuant to the PSLRA, Petitioners and their *amici* have already received the functional equivalent of the narrowed permissible inferences recognized in *Matsushita*.[10] Third, decisions of this Court subsequent to *Matsushita* have emphasized that it "did not introduce a special burden on plaintiffs facing summary judgment in antitrust cases," but "demands only that the nonmoving party's inferences be reasonable in order to reach the jury, a requirement that was not invented, but merely articulated, in that decision." *Eastman Kodak Co. v. Image Technical Services, Inc.*, 504 U.S. 451, 468-469 (1992) (footnote omitted). Thus, *Matsushita*'s applicability is narrowly limited to an antitrust plaintiff's burden in

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[10] As discussed below, securities fraud litigation is vastly different now than prior to the enactment of the PSLRA. Even apart from the innovations of the PSLRA, such as the lead plaintiff requirements, 15 U.S.C. § 78u-4(a)(3), there are a whole panoply of devices under the Federal Rules of Civil Procedure, such as presumptive limits on the length of time of depositions, *see* FED. R. CIV. PROC. 30(d)(2), and immediate (albeit discretionary) appeal of class certification decisions, *see* FED. R. CIV. PROC. 23(f), that curtail the supposed abuses attendant with private securities litigation. Therefore, references by Petitioners and their *amici* to "fishing expeditions" and "blackmail settlements" must be viewed in the context of ***present day*** rules of procedure, and the source of these contentions must be taken into account. *See, e.g., Blue Chip Stamps*, 421 U.S. at 740 (recognizing "the common complaint of the many defendants who would prefer avoiding lawsuits entirely to either settling them or trying them").

opposing summary judgment. It has no applicability outside of that narrow area.

But just as there was no language within Section 21D(b)(2) specifying the type of allegations that may be considered to give rise to a strong inference of scienter, so too there is no language requiring a district court to weigh competing inferences on a motion to dismiss. To the contrary, Section 21D(b)(2)'s use of "inference" acknowledges the distinction between pleading scienter on the basis of a complaint and proving scienter after full discovery has taken place (a distinction that Petitioners seek to blur by invoking *Matsushita*). For example, allegations of "motive and opportunity" that may give rise to an inference of scienter are used by courts "to weed out those cases where scienter was plausible from those in which there was no hope of ever proving fraudulent intent." Olazabal, 6 STAN. J.L. BUS. & FIN. at 168 n.78. *See also* Donald C. Langevoort, *Reflections On Scienter (And The Securities Fraud Case Against Martha Stewart That Never Happened)*, 10 LEWIS & CLARK L. REV. 1, 7 (2006) ("The pleading requirement is about whether plaintiffs get to go to discovery, where solid evidence about awareness or appreciation can be elicited through document production and depositions. Allegations of motive are made important because they help distinguish between strong and weak cases at that early stage, before the pressure to settle becomes overwhelming"). This winnowing function explains courts' conclusions that, even after the PSLRA, "[i]nferences must be reasonable and strong – but not irrefutable." *Helwig*, 251 F.3d at 553; *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 78 (1st Cir. 2002) ("The plaintiff must also show that the inferences of scienter are both reasonable and strong") (citations and internal quotations omitted).

For these reasons, it is clear that Section 21D(b)(2) does not alter the traditional standard used to judge motions to dismiss. *See Aldridge*, 284 F.3d at 78 ("Even under the PSLRA, the district court, on a motion to dismiss, must draw all reasonable inferences from the

particular allegations in the plaintiff's favor, while at the same time requiring the plaintiff to show a strong inference of scienter"); *Helwig*, 251 F.3d at 553 ("Plaintiffs need not foreclose all other characterizations of fact, as the task of weighing contrary accounts is reserved for the fact finder"); *but see id.* at 553 ("[p]laintiffs are entitled only to the most plausible of competing inferences"); *see also JP Morgan Chase Bank v. Winnick*, 406 F. Supp. 2d 247, 250 n.2 (S.D.N.Y. 2005) (finding "no contradiction between permitting all reasonable inferences to be drawn in favor of the plaintiff, and yet requiring that these inferences of scienter be sufficiently strong to satisfy Rule 9(b)"); *In re Alstom SA Sec. Litig.*, 454 F. Supp. 2d 187, 207 n.16 (S.D.N.Y. 2006) (same, construing Section 21D(b)(2)). Thus, the court below was correct in concluding that, once a "strong inference" of scienter is presented, Section 21D(b)(2) of the PSLRA requires nothing more. *See Tellabs*, 437 F.3d at 602; *Pirraglia*, 339 F.3d at 1188 ("If a plaintiff pleads facts with particularity that, in the overall context of the pleadings, including potentially negative inferences, give rise to a strong inference of scienter, the scienter requirement of the [PSLRA] is satisfied").

3. Weighing "Innocent Inferences" Against "Culpable Inferences" On A Motion To Dismiss Will Turn Securities Fraud Actions Into Mini-Trials On The Pleadings.

If this Court adopts the arguments of Petitioners and their *amici* and requires courts to engage in the delicate and factually based weighing of "innocent inferences" against "culpable inferences," it will curtail plaintiff's rights by permitting defendants to turn the face of a securities fraud complaint into a mini-trial on the merits at the pleading stage, before the plaintiff has the benefit of any formal discovery that is uniquely in the hands of defendants. To prevail at this pleadings "mini-trial," defendants will advance every conceivable self-serving "innocent inference" and seize upon the well-accepted principle that when ruling on a motion to dismiss, a court

may properly consider documents referenced in a complaint though not attached, so long as neither party questions the authenticity of those documents. *See, e.g., Chambers v. Time Warner, Inc.*, 282 F.3d 147, 153 (2d Cir. 2002) ("court may consider 'documents attached to the complaint as an exhibit or incorporated in it by reference, . . . matters of which judicial notice may be taken, or . . . documents either in plaintiffs' possession or of which plaintiffs had knowledge and relied on in bringing suit'") (citation omitted); *Collins v. Morgan Stanley Dean Witter*, 224 F.3d 496, 498-99 (5th Cir. 2000) (court may consider materials "referred to in the plaintiff's complaint and . . . central to her claim") (quoting *Venture Assocs. Corp. v. Zenith Data Sys. Corp.*, 987 F.2d 429, 431 (7th Cir. 1993)); *Parrino v. FHP, Inc.*, 146 F.3d 699, 705-06 (9th Cir.), *cert. denied*, 525 U.S. 1001 (1998) (on motion to dismiss, court may consider documents not attached to complaint yet crucial to the claim). This includes documents that are integral to a plaintiff's claim but not explicitly incorporated in the complaint. *Parrino*, 146 F.3d at 706. A district court may also consider matters that are properly the subject of judicial notice when ruling upon a motion to dismiss without converting the motion into one for summary judgment. *Barron v. Reich*, 13 F.3d 1370, 1377 (9th Cir. 1994).[11]

Accordingly, culpable corporate defendants who are engaged in misconduct will have an incentive to publish information in the midst of the fraud that can later be used to create an "innocent inference" from the face of the pleadings when faced with a securities fraud complaint. For example, a corporate defendant engaged in overstating financial results could publish revised future sales or

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[11] For example, information obtained from a website, where neither party questions the authenticity of the site or the document, meets the definition of Federal Rule of Evidence 201 and is a proper subject of judicial notice. *Pollstar v. Gigmania Ltd.*, 170 F. Supp. 2d 974, 978 (E.D. Cal. 2000) (taking judicial notice of website printout referenced in complaint when ruling on motion to dismiss).

earnings projections, or make statements on its website, that would lessen investor expectations as the fraud is tapered off and then rely on the downward revision to create an innocent inference if the fraud is ever revealed. Although a plaintiff may allege particularized facts that give rise to a strong inference of scienter, such as statements from confidential sources, under Petitioners' proposed standard, the district court would nonetheless be required to offset the strong inference of scienter with innocent inferences created from the downward revision. In the same vein, a defendant who knowingly overstates revenue and income through fraudulent vendor credits could then commission a study of vendor credits or overhaul the vendor credit system and later contend that such actions are inconsistent with culpable conduct, when in fact the study or overhauled system concealed the fraud and its impact on the issuer's financial results.

Consideration of such self-serving actions is properly reserved for a motion for summary judgment or for trial, when a jury can properly and thoroughly consider the weight of the evidence and the credibility of witnesses, and after plaintiffs have had an opportunity for formal discovery to fully explore events surrounding the supposed innocent inference. To offset a strong inference of scienter with any innocent inferences that a defendant may be able to construct at the pleadings stage would result in the dismissal of otherwise meritorious claims and would be contrary to the stated intention of the PSLRA.

4. Weighing "Innocent Inferences" Against "Culpable Inferences" On A Motion To Dismiss Improperly Invades The Province Of The Jury.

Scienter is a question of fact and is normally to be decided by a jury. *See, e.g., In re Cerner Corp. Sec. Litig.*, 425 F.3d 1079, 1084-1085 (8th Cir. 2005); *In re K-Tel Int'l*, 300 F.3d at 894; *Press*, 166 F.3d at 538. Thus, Section 21D(b)(2)'s use of the term "inference" is significant. An

inference is merely a conclusion or deduction the fact-finder may in its discretion reach, but is not required to draw as a matter of law. *See* Michael H. Graham, HANDBOOK OF FEDERAL EVIDENCE § 301:7 (6th ed. 2006); *see also Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1105 (10th Cir. 2003) ("An inference is a logical conclusion drawn from the facts") (citation omitted).[12] This meaning is also consistent with decisions pre-dating the PSLRA from the Second Circuit and elsewhere acknowledging that proof of scienter is usually a matter of inferences drawn from circumstantial evidence. *See, e.g., Wechsler v. Steinberg*, 733 F.2d 1054, 1058-1059 (2d Cir. 1984); *State of Ohio v. Peterson, Lowry, Rall, Barber & Ross*, 651 F.2d 687, 695 (10th Cir.), *cert. denied*, 454 U.S. 895 (1981). This Court has likewise recognized that "the *proof* of scienter required in fraud cases is often a matter of inference from circumstantial evidence." *See Herman & MacLean*, 459 U.S. at 390 n.30 (emphasis added). *See also Greebel*, 194 F.3d at 195 (the PSLRA "plainly contemplated that scienter could be *proven* by inference, thus acknowledging the role of indirect and circumstantial evidence") (emphasis added).

The court below was properly hesitant to interpret Section 21D(b)(2)'s "strong inference" language as allowing plaintiffs only "the most plausible of competing inferences" because it recognized that such a standard could be considered "a usurpation of the jury's role." *Tellabs*, 437 F.3d at 602.[13] Rather than potentially intrude on a jury

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[12] In this respect, an inference is distinguishable from a presumption, which is a legally compelled conclusion. *See* FED. R. EVID. 301. Congress understood the difference between the two terms, as demonstrated by the use of "presumption" in the PSLRA's "lead plaintiff" provisions. *See* 15 U.S.C. § 78u-4(a)(3)(B)(iii).

[13] Indeed, this concern was initially raised by a different panel of the Sixth Circuit from the one that first announced this controversial standard. *See City of Monroe Employees Retirement System v. Bridgestone Corp.*, 399 F.3d 651, 683 n.25 (6th Cir. 2005) (suggesting that "a Seventh Amendment Problem" may be presented "where a juror could conclude that the facts pleaded showed scienter, but that conclusion would not be the most plausible of competing inferences"); *see also*

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function, the *Tellabs* court correctly concluded that, once a strong inference of scienter was raised by the plaintiff's complaint, it would survive a motion to dismiss as long as "it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." *Id.*

Although Petitioners and their *amici* (including the SEC) dismiss this concern, the ***practical*** effect of the standard that they seek to have this Court impose on securities fraud complaints invites an intrusion on the role of a jury, and simply because the court below raised the issue *sua sponte* is no reason for this Court to ignore the import of what it is being asked to do. Inviting a district court to weigh competing inferences clearly usurps a role traditionally assigned to a jury. *See, e.g., Continental Ore Co. v. Union Carbide & Carbon Corp.*, 370 U.S. 690, 700-701 (1962), *superceded by statute on other grounds*, 15 U.S.C. § 6a (a jury "'weighs the contradictory evidence and inferences' and draws 'the ultimate conclusion as to the facts'") (citation omitted); *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 255 (1986) ("Credibility determinations, the weighing of the evidence, and the drawing of legitimate inferences from the facts are jury functions, not those of a judge, . . . ").

Decades ago a member of this Court voiced concern over the "gradual process of judicial erosion which in one hundred fifty years has slowly worn away a major portion of the essential guarantee of the Seventh Amendment." *Galloway v. United States*, 319 U.S. 372, 397 (1943) (Black, J., *dissenting*). More recently, commentators have noted the increase with which fundamental jury functions, such as "commonsense determinations about human behavior, reasonableness, and state of mind based on objective standards, . . . have been taken away from juries by pretrial disposition . . . . " Arthur R. Miller, *The Pretrial Rush To Judgment: Are The "Litigation Explosion," "Liability*

Helwig, 251 F.3d at 553 (announcing the "most plausible of competing inferences" standard).

Crisis," And Efficiency Cliches Eroding Our Day In Court And Jury Trial Commitments?, 78 N.Y.U. L. REV. 982, 1134 (2003). Yet, as noted by then-Associate Justice Rehnquist in discussing the historical importance of the right to trial by jury, "[t]hose who passionately advocated the right to a civil jury trial did not do so because . . . [of] a belief that the use of juries would lead to more efficient judicial administration" but, rather, it "was important to the founders because juries represent the layman's common sense, the 'passional elements in our nature,' and thus keep the administration of law in accord with the wishes and feelings of the community." *Parklane Hosiery Co., Inc. v. Shore*, 439 U.S. 322, 343-344 (1979) (Rehnquist, J., *dissenting*).

This Court has recognized that "[m]aintenance of the jury as a fact-finding body is of such importance and occupies so firm a place in our history and jurisprudence that any seeming curtailment of the right to a jury trial should be scrutinized with the utmost care." *Beacon Theatres, Inc. v. Westover*, 359 U.S. 500, 501 (1959); *see also Jacob v. City of New York*, 315 U.S. 752, 752 (1942) (recognizing right to a jury trial in civil cases as "a basic and fundamental feature of our system of federal jurisprudence" that "should be jealously guarded by the courts"). This Court has likewise deemed it a "cardinal principle" of statutory construction that where "the validity of an act of the Congress is drawn in question, and . . . a serious doubt of constitutionality is raised," the Court should "first ascertain whether a construction of the statute is fairly possible by which the question may be avoided." *Crowell v. Benson*, 285 U.S. 22, 62 (1932); *see also Boos v. Barry*, 485 U.S. 312, 331 (1988); *New York v. Ferber*, 458 U.S. 747, 769, n.24 (1982). In this instance, consistent with these pronouncements, the Court should not adopt a construction of Section 21D(b)(2)'s "strong inference" requirement that would permit the weighing of competing inferences on a motion to dismiss.

B. PRIVATE ACTIONS SERVE AN ESSENTIAL FUNCTION IN THE SECURITIES MARKETPLACE TO DETER FRAUDULENT MISCONDUCT AND COMPENSATE HARMED INVESTORS.

The PSLRA was intended to address "perceived abuses of the class-action vehicle in litigation involving nationally traded securities." *Dabit*, 126 S. Ct. at 1510. However, there has been continuing debate regarding the validity of these "perceived abuses." *See, e.g.*, Joel Seligman, *Rethinking Private Securities Litigation*, 73 U. CINN. L. REV. 95, 97-98 (2004) (explaining that a study used by backers of the PSLRA to suggest that securities class action settlements amounted to "a trivial percentage of the potential damages" actually confused "investor losses with recoverable damages"); Leonard B. Simon & William S. Dato, *Legislating on a False Foundation: The Erroneous Academic Underpinnings of the Private Securities Litigation Reform Act of 1995*, 33 SAN DIEGO L. REV. 959, 962, 972 (1996) (explaining that, because a study relied upon by proponents of the PSLRA was "fundamentally flawed," the PSLRA "cannot solve the 'problem' identified by [the study], because the 'problem' [] described does not exist;" noting, for example, that "limited insurance coverage and defendant's inability to satisfy a judgment" are "uncontrolled-for factors" that can cause "a strong case on the merits [to settle] for about the same amount as a weaker case without similar problems"); John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAWYER 335, 340 (1996) (noting that although "witnesses gave anecdotal evidence of widespread abuses in the private litigation system, . . . the empirical evidence was inconclusive") (footnotes omitted). Indeed, the supposed ineffectiveness of federal courts to curtail frivolous lawsuits through the use of Federal Rule of Civil Procedure 9(b) – one of the main objections of the proponents of the PSLRA – was not, even prior to the debate over the PSLRA, universally accepted. *See, e.g.*, Jeff Sovern, *Reconsidering Federal*

Civil Rule 9(b): Do We Need Particularized Pleading Requirements In Fraud Cases, 104 F.R.D. 143, 154 (1985) (commenting that "Rule 9(b) may permit a guilty defendant to hide behind insufficient pleadings to prevent the truth from emerging"); Note, *Pleading Securities Fraud Claims With Particularity Under Rule 9(b)*, 97 HARV. L. REV. 1432, 1432 (1984) (observing that "defendants in securities fraud actions have been winning motions to dismiss under Rule 9(b) with increasing frequency").

It is recognized, however, that the PSLRA was not intended to eliminate meritorious securities fraud complaints. *See, e.g., Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1235 (9th Cir. 2004) ("The PSLRA was designed to eliminate frivolous actions, but not actions of substance"); *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 354 (5th Cir. 2002) ("[The PSLRA] was not enacted to raise the pleading burdens under Rule 9(b) and section 78u-4(b)(1) to such a level that facially valid claims, which are not brought for nuisance value or as leverage to obtain a favorable or inflated settlement, must be routinely dismissed on Rule 9(b) and 12(b)(6) motions. . . . [T]he PSLRA may have changed federal securities law; it did not eliminate it") (citations omitted); S. REP., at 6 (PSLRA was "intended to encourage plaintiffs' lawyers to pursue valid claims for securities fraud . . . "). It is also clear, despite the invective of Petitioners and their *amici*, that the PSLRA is achieving its goals of preventing the filing of "strike suits" and eliminating lawyer driven litigation.[14] *See, e.g.*, Stephen

[14] The *amicus curiae* brief of The Securities Industry and Financial Markets Association and The Chamber of Commerce of the United States of America ("SIFMA/Chamber of Commerce") in support of Petitioners is disingenuous. For example, SIFMA/Chamber of Commerce note with alarm that "seven of the ten largest [securities fraud class action] settlements ever" occurred within the last two years, *see* SIFMA/Chamber of Commerce *amicus* br. at 8, but fail to appreciate that these settlements, such as WorldCom, involved massive, egregious frauds in which billions of dollars of investor capital was eliminated. Moreover, this observation does not put the fraudulent conduct in

(Continued on following page)

J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes After The First Decade After The PSLRA*, 106 COLUM. L. REV. 1489, 1501, 1503-1506 (2006) (citing a study indicating that, with respect to companies with highly volatile stocks, the PSLRA has discouraged "frivolous litigation, but not meritorious litigation," and noting, *inter alia*, that "[t]he participation rate of institutional investors . . . has grown significantly since 2000," with "[a]necdotal evidence" indicating that institutional investors have been able to "develop more effective case supervision and fee agreements").

1. The PSLRA's Lead Plaintiff Provision Has Curbed Supposed Lawyer-Driven Litigation.

Petitioners and their *amici* ignore that the "lead plaintiff" provision, 15 U.S.C. § 78u-4(a)(3)(B), is the PSLRA's principal prophylactic measure to deter lawyer driven litigation and prevent the filing of unmeritorious "strike suits." *See, e.g., Hevesi v. Citigroup Inc.*, 366 F.3d 70, 82 n.13 (2d Cir. 2004) ("lead plaintiff" provision was intended to "empower investors so that they – not their lawyers – exercise primary control over private securities litigation") (quoting S. REP., at 4); *In re Cendant Corp. Sec. Litig.*, 404 F.3d 173, 180 (3d Cir. 2005) (PSLRA created "a paradigm in which the plaintiff with the largest stake in

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context, since most of the actions arose prior to the passage of the Sarbanes-Oxley Act of 2002, PUB. L. NO. 107-204, 116 Stat. 745 (codified in scattered sections of 15 & 18 U.S.C.). Finally, SIFMA/Chamber of Commerce ignore that larger settlements may be the result of the PSLRA's impact of allowing only potentially meritorious claims to proceed past the motion to dismiss. In addition, notably absent from the SIFMA/Chamber of Commerce brief is the "flip-side" of the PSLRA – the sharp decrease in the number of securities fraud class actions being filed and that the dismissal rate of securities fraud complaints has nearly doubled since passage of the PSLRA. *See* Todd Foster, Ronald I. Miller, Ph.D. & Stephanie Plancich, Ph.D., *Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar*, NERA ECONOMIC CONSULTING STUDY (Jan. 2007) ("*Recent Trends*"), at 2-4 (available at www.nera.com/Publication.asp?p_ID=3028).

the case, usually a large and sophisticated institution, is accorded the status of lead plaintiff and assigned the right to appoint and duty to monitor lead counsel for the class"). This provision favors the appointment of large and sophisticated institutional investors who have the ability to actively participate in the class action and monitor the progress of class counsel, thus reducing agency costs that may arise when class counsel's interests diverge from those of the shareholders. *See, e.g.*, Jill E. Fisch, *Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction*, 102 COLUM. L. REV. 650, 708 (2002) (noting that institutions serving as lead plaintiff "appear acutely sensitive to agency issues and readily defend their chosen fee structures in terms of minimizing agency costs") (footnote omitted). As a result, the control of securities class action litigation has been significantly transferred from ostensibly disinterested individuals who may have a diminutive financial interest in the case and only minimal oversight of class counsel, to large, sophisticated institutional investors who have a much greater financial interest in the outcome of the litigation and who have the ability and means to select competent class counsel. *See, e.g.*, Laura E. Simmons & Ellen M. Ryan, *Post-Reform Act Securities Settlements: 2005 Review and Analysis*, CORNERSTONE RESEARCH ESSAY (2006) ("*Post-Reform Securities Settlements*"), at 9 (available at http://tinyurl.com/ywhf7w) (noting the increase in the percentage of institutional investors serving as lead plaintiffs since passage of the PSLRA); Choi & Thompson, 106 COLUM. L. REV. at 1505 (citing studies indicating that "cases with institutional investors as lead plaintiffs have higher settlement amounts than other class action securities fraud cases") (footnote omitted).

2. The PSLRA's Discovery Stay, Together With Amendments To The Federal Rules Of Civil Procedure, Has Severely Diminished "Strike Suits."

This Court has long identified so-called "strike suits" as a source of concern. *See, e.g.*, *Cohen v. Beneficial Loan*

Corp., 337 U.S. 541, 548 (1949) (describing "strike suits" as actions "brought not to redress real wrongs, but to realize upon their nuisance value"). Although initially directed toward shareholder derivative actions, the term "strike suit" was later used to encompass securities fraud class actions. *See* Choi & Thompson, 106 COLUM. L. REV. at 1492-93. The legislative history of the PSLRA is clear in this respect – part of the impetus for the legislation's passage was the ancedotal accounts of the PSLRA's corporate proponents who claimed that the unrestrained cost of discovery often forced corporate defendants to settle "strike suits" in order to avoid the cost of litigation. *See* S. REP., at 4, 9.

The PSLRA's "approach to pretrial discovery [is] akin to a sledgehammer." Seligman, 73 U. CINN. L. REV. at 117. Section 21D(b)(3)(B) mandates a stay of discovery "during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party." 15 U.S.C. § 78u-4(b)(3)(B). The discovery stay is intended to prevent perceived pre-PSLRA abusive discovery tactics by directing district courts to first determine the legal sufficiency of the claims in securities fraud class actions before permitting any discovery to be served. *See Lander v. Hartford Life & Annuity Insurance Co.*, 251 F.3d 101, 107 (2d Cir. 2001).

When considered with changes to the Federal Rules of Civil Procedure in the years following passage of the PSLRA, it is apparent that the perception of securities fraud class actions as a vehicle for unfettered discovery is now out-dated. In 2000, amendments to Rule 26 narrowed the scope of discovery. Although discovery had been available, since adoption of the Federal Rules of Civil Procedure in 1938, for anything "relevant to the subject matter of the action," that scope was curtailed to areas "relevant to a claim or defense in the action." FED. R. CIV. PROC. 26(b)(1). This amendment was intended to "signal[]" district courts to exercise their "authority to confine discovery" and to "regulat[e] the breath of sweeping or contentious discovery." *See* FED. R. CIV. PROC. 26, Advisory

Committee Notes to 2000 amendments. The Federal Rules of Civil Procedure now impose presumptive limits on both the number of depositions and their length of time. *See* FED. R. CIV. PROC. 30(a)(2)(A), (d)(2). When considered with the PSLRA's discovery stay, it is clear that assuming *arguendo* that discovery costs alone ever prompted settlement, that leverage has dissipated, if not disappeared entirely.

3. Securities Class Action Filings Are At An All-Time Low And Dismissal Rates Are At An All-Time High Since Passage Of The PSLRA.

Securities fraud class action filings have fallen to an all-time low and dismissal rates are at an all-time high since enactment of the PSLRA, two facts that militate against a heightened pleading standard that would require a district court, having found a strong inference of scienter, to offset that determination with supposed "innocent inferences" to be interpreted from the pleadings or extracted from documents that defendants will invariably append, when possible, to Rule 12(b)(6) motions to dismiss that are filed in virtually every federal securities class action.

According to NERA Economic Consulting, the drop-off in filings began in 2005 and accelerated through 2006. *See Recent Trends* at 2. The 129 securities fraud class actions filed in 2006 (of which 22 were novel options back-dating cases) was well below the annual post-PSLRA average of 239 filings annually. *See id.* at 1-2, 4 (observing that "[a]nnual 2006 federal filings were at the lowest level since 1996 – a year that was itself unusually low because many filings were moved to state courts in an attempt to bypass the restrictions imposed by the [PSLRA]"). The number of 2006 filings, through December 15, 2006, represents a 36% drop from 2005 levels, and a 44% decline from the post-PSLRA average. *Id.*

While securities class action filings are markedly down since passage of the PSLRA, dismissal rates of securities class actions have risen measurably. Between

1991 and 1995, dismissals accounted for just under 20% of dispositions of securities fraud class actions. *See id.* at 4. However, between 2000 and 2004, that rate increased to 38.2%. *See id.* It is apparent from these figures that Section 21D(b)(2)'s heightened pleading requirement, particularly when combined with the PSLRA's discovery stay, is having its intended effect.[15]

V. CONCLUSION

NCPERS and NASCAT submit that the Seventh Circuit correctly refused to endorse the weighing of competing inferences at the motion to dismiss stage. Neither the text of Section 21D(b)(2) nor public policy requires such a drastic change in the traditional deference accorded to a plaintiff's complaint. Moreover, since empirical evidence indicates that the PSLRA is having its intended effect, the position of Petitioners and their *amici* is a solution in search of a problem. For the reasons stated above, there is no reason to make a defrauded investor's task of deterring future fraud and obtaining compensation more difficult than it is currently.

Dated: March 8, 2007

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[15] Moreover, as courts and commentators had predicted, *see, e.g.*, *Lander*, 251 F.3d at 107, the PSLRA may have discouraged meritorious, albeit smaller, private securities actions. The Cornerstone Research study cited by SIFMA/Chamber of Commerce indicates a downward trend of smaller settlements (less than $10 million) as a percentage of all securities fraud class action settlements. *See Post-Reform Securities Settlements* at 3.

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Supreme Court of the United States

TELLABS, INCORPORATED and RICHARD C. NOTEBAERT,

Petitioners,

—v.—

MAKOR ISSUES & RIGHTS, LTD., *et al.*,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR NEW ENGLAND LEGAL FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICUS CURIAE*[1]

New England Legal Foundation ("NELF") is a non-profit, public interest law firm that was founded in 1977. Its membership consists of corporations, law firms, individuals, and others who believe in NELF's mission of promoting balanced economic growth for New England, protecting the free enterprise system, and defending economic rights. NELF's more than 130 members and supporters include a cross-section of large and small corporations from all parts of New England and the United States. NELF has regularly appeared in state and federal courts, as party or counsel, in cases raising issues of general economic significance to the New England and national business communities. *E.g.*, *Watters* v. *Wachovia Bank, N.A.*, No. 05-1342 (U.S. argued Nov. 29, 2006); *Rapanos* v. *United States*, 126 S. Ct. 2208 (2006); *S.D. Warren Co.* v. *Maine Bd. of Envtl. Protection*, 126 S. Ct. 1843 (2006); *Kelo* v. *City of New London*, 545 U.S. 469 (2005); *Green Tree Fin. Corp.* v. *Bazzle*, 539 U.S. 444 (2003); *EEOC* v. *Waffle House, Inc.*, 534 U.S. 279 (2002); *Palazzolo* v. *Rhode Island*, 533 U.S. 606 (2001); *Crosby* v. *National Foreign Trade Council*, 530 U.S. 363 (2000); *UNUM Life Ins. Co.* v. *Ward*, 526 U.S. 358 (1999).

SUMMARY OF ARGUMENT

At issue in this case is what it means, under the Private Securities Litigation Reform Act of 1995, to require a plaintiff in a private securities fraud action to "state

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[1] Pursuant to Rule 37.6, NELF states that this brief was not authored in whole or in part by counsel for any party, and that no person or entity other than NELF or its counsel made a monetary contribution to the preparation or submission of this brief. The parties' general letters of consent to the filing of *amicus* briefs have been filed with the Clerk's office.

with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Congress did not choose that language at random. Part of it—the "facts giving rise to a strong inference" part—comes directly from cases in the Second Circuit applying Federal Rule of Civil Procedure 9(b). In those cases, the Second Circuit held that plaintiffs in fraud cases had to plead "facts giving rise to a strong inference of fraudulent intent." At the same time, however, because the text of Rule 9(b) provides that "[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally," the Second Circuit tempered its "strong inference" standard by holding that "great specificity" was not required; a "minimal factual basis" would suffice.

Congress's choice of words clearly evinces an intent to toughen this standard. Unlike Rule 9(b)—which explicitly exempts state of mind from the facts that must be "stated with particularity"—the PSLRA *requires* that facts as to a defendant's state of mind be "state[d] with particularity." And the legislative history confirms that Congress meant to create a new and stricter pleading standard. Not only did the Conference Report on the final bill explicitly say that "the Conference Committee intends to *strengthen* existing pleading requirements,"[2] but President Clinton vetoed the bill precisely because he understood Congress had made "crystal clear . . . [its] intent to raise the [pleading] standard *even beyond*" existing Rule 9(b) case law and "to erect a *higher* barrier to bringing suit than any now existing."[3]

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[2] H.R. CONF. REP. NO. 104-369, at 41 (1995) (emphasis added).

[3] Private Securities Litigation Reform Act of 1995—Veto Message from the President of the United States, H.R. DOC. NO. 104-150 (emphasis added), *reprinted in* 141 CONG. REC. H15214-15 (daily ed. Dec. 20, 1995). Congress overrode the President's veto. 141 CONG. REC. D1511 (daily ed. Dec. 22, 1995).

All of this means that the decision of the Seventh Circuit below cannot stand. The standard applied by the Seventh Circuit—which would sustain any complaint from which "a reasonable person *could* infer" scienter, Pet. App. 20a (emphasis added)—applies a "reasonable inference" standard that is contrary to the "strong inference" language of the statute itself. Indeed, the Seventh Circuit's standard threatens to revive the discredited practice of pleading "fraud by hindsight," widely rejected even before the PSLRA's passage. The Seventh Circuit's "reasonable inference" standard accomplishes exactly the opposite of what Congress intended, because it allows plaintiffs to bring exactly the sorts of ill-founded claims that the PSLRA was intended to bar.

ARGUMENT

I. THE PSLRA ESTABLISHES A SCIENTER PLEADING STANDARD MORE STRINGENT THAN THE STRICTEST INTERPRETATION OF FED. R. CIV. P. 9(B).

A. The PSLRA's language was borrowed, in part, from the Second Circuit's strict scienter pleading standard.

The PSLRA requires plaintiffs to plead "*facts giving rise to a strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added). When it was enacted into law in 1995, that language was not new to the realm of private securities fraud litigation. The very same "strong inference" language appears in a line of Second Circuit cases dating back to the 1970s. Those cases consistently held that, in any civil case involving an allegation of fraud, Federal Rule of Civil Procedure 9(b) required plaintiffs to allege "*facts giving rise to a strong inference* of fraud-

ulent intent." *Acito* v. *IMCERA Group, Inc.*, 47 F.3d 47, 52 (2d Cir. 1995) (emphasis added).[4]

At the time the PSLRA was passed, "the Second Circuit's 'strong inference' standard was the most stringent among the Courts of Appeals." *Nathenson* v. *Zonagen Inc.*, 267 F.3d 400, 407 (5th Cir. 2001); *accord, e.g., In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 549 (6th Cir. 1999). Other courts of appeals used less forceful formulations, ones that did not use the word "strong"—requiring, for example, that a complaint "set forth specific facts that make it reasonable to believe that defendant knew that a statement was materially false or misleading," *Greenstone* v. *Cambex Corp.*, 975 F.2d 22, 25 (1st Cir. 1992) (Breyer, Ch. J.); that a complaint "afford a basis for believing that plaintiffs could prove scienter," *DiLeo* v. *Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990); or that it "set forth specific facts that support an inference of fraud," *Tuchman* v. *DSC Communications Corp.*, 14 F.3d 1061, 1067 (5th Cir. 1994).

Some courts rejected the Second Circuit's approach on the ground that it was inconsistent with the text of Rule 9(b). The first sentence of Rule 9(b) requires "particu-

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[4] *Accord, e.g., Shields* v. *Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994) ("to serve the purposes of Rule 9(b), we require plaintiffs to allege facts that give rise to a strong inference of fraudulent intent"); *Mills* v. *Polar Molecular Corp.*, 12 F.3d 1170, 1176 (2d Cir. 1993) ("a 10b-5 complaint . . . must allege facts that raise a strong inference of fraudulent intent"); *Beck* v. *Manufacturers Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987) ("factual allegations must give rise to a 'strong inference' that the defendants possessed the requisite fraudulent intent"); *Ross* v. *A.H. Robins Co., Inc.*, 607 F.2d 545, 558 (2d Cir. 1979) ("requir[ing] that plaintiffs specifically plead those events which they assert give rise to a strong inference that the defendants had knowledge of the [allegedly omitted or misstated] facts . . . or recklessly disregarded their existence").

larity" only as to the "circumstances constituting fraud or mistake"—

> In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be alleged with particularity.

—and the second and last sentence provides that "intent, knowledge and other condition of mind" need only be "averred generally":

> Malice, intent, knowledge, and other condition of mind of a person can be averred generally.

FED. R. CIV. P. 9(b). The Ninth Circuit, for example, held that "the Second Circuit's test . . . is irreconcilable with the second sentence of Rule 9(b)," and that "Rule 9(b) does not require '*any* particularity in connection with an averment of intent, knowledge or condition of the mind.' " *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1545 (9th Cir. 1994) (en banc; citation omitted).

For its part, the Second Circuit attempted to harmonize its "strong inference" standard with Rule 9(b)'s text by significantly tempering the standard with language that Congress ultimately did *not* put into the PSLRA. The court acknowledged that, for allegations of "condition of mind" such as scienter, the second sentence of Rule 9(b) represented a "relaxation of [the] specificity requirement" contained in the first sentence of the rule. *Acito*, 47 F.3d at 52; *accord Shields* v. *Citytrust Bancorp. Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994). The court thus held that "allegations of scienter . . . 'are not subjected to the more exacting consideration applied to the other components of fraud,' " *Breard* v. *Sachnoff & Weaver, Ltd.*, 941 F.2d 142, 143 (2d Cir. 1991) (quoting *Ouaknine* v. *MacFarlane*, 897 F.2d 75, 81 (2d Cir. 1990))—and that, accordingly, " 'scienter need *not* be alleged with great specificity.' " *IUE AFL-CIO Pension*

Fund v. *Herrmann*, 9 F.3d 1049, 1057 (2d Cir. 1993) (quoting *Ouaknine*, 897 F.2d at 79-80; emphasis added).[5] Instead, the Second Circuit required plaintiffs to plead only "a *minimal* factual basis for their conclusory allegations of scienter." *Connecticut Nat'l Bank* v. *Fluor Corp.*, 808 F.2d 957, 960 (2d Cir. 1987) (emphasis added).[6]

One way of establishing a "minimal factual basis" for scienter, under the Second Circuit's standard, was "through allegations of a motive to deceive and access to accurate information." *Cohen* v. *Koenig*, 25 F.3d 1168, 1173-74 (2d Cir. 1994). In other words, a plaintiff could establish the required inference of scienter by "alleg[ing] facts showing a motive for committing fraud and a clear opportunity for doing so." *Beck* v. *Manufacturers Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987). Known as the "motive and opportunity test," this hold-

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[5] *Accord, e.g.*, *Cohen* v. *Koenig*, 25 F.3d 1168, 1173 (2d Cir. 1994) ("the language of Rule 9(b) means that 'great specificity [is] not required with respect to . . . allegations of . . . scienter' "; citations omitted); *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268 (2d Cir. 1993) ("[s]cienter . . . need not be pleaded with 'great specificity' "; citation omitted); *Wexner* v. *First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990) ("scienter need not be alleged with great specificity"); *Connecticut Nat'l Bank* v. *Fluor Corp.*, 808 F.2d 957, 962 (2d Cir. 1987) ("Consistent with the language of the Rule [9(b)], we have recognized that 'great specificity [is] not required with respect to . . . allegations of . . . scienter' ").

[6] *Accord, e.g.*, *Powers* v. *British Vita, P.L.C.*, 57 F.3d 176, 184 (2d Cir. 1995) ("plaintiff must 'provide some minimal factual basis for conclusory allegations of scienter' "; citation omitted); *Cohen*, 25 F.3d at 1173 ("plaintiffs have the 'burden of pleading circumstances that provide at least a minimal factual basis for their conclusory allegations of scienter' "; citation omitted); *see also San Leandro Emergency Medical Group Profit Sharing Plan* v. *Philip Morris Cos., Inc.*, 75 F.3d 801, 813 (2d Cir. 1996) ("minimal factual basis"; citation and internal quotation marks omitted); *Chill* v. *General Electric Co.*, 101 F.3d 263, 267 (2d Cir. 1996) (same).

ing was something of a shortcut to pleading scienter. It allowed plaintiffs to plead fraud *without* pleading "strong circumstantial evidence of conscious misbehavior or recklessness." *Acito*, 47 F.3d at 52. The "motive and opportunity test" made it easier to plead fraud, and "lower[ed] the bar for securities fraud cases," because "[g]reed is a ubiquitous motive, and corporate insiders and upper management always have opportunity to lie and manipulate." *Bryant* v. *Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir. 1999) (citation and internal quotation marks omitted).

The PSLRA did not incorporate any of the Second Circuit's efforts to soften the "strong inference" test. Most importantly, the PSLRA's language directly *contradicts* the holdings that scienter allegations must be subjected to a "relaxed" standard of particularity, that only a "minimal factual basis," and not "specificity," are required, and that, in accordance with Rule 9(b), allegations of conditions of mind "are not subjected to the more exacting consideration applied to the other components of fraud." By its express terms, the PSLRA's pleading standard merges *the "particularity" language of the first sentence of Rule 9(b)* with the "strong inference" language in the Second Circuit case law, and applies it to the state of mind requirement—

> (2) REQUIRED STATE OF MIND.—In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, *the complaint shall*, with respect to each act or omission alleged to violate this title, *state with particularity* facts giving rise to a strong inference that the defendant acted with the required state of mind.

—and, in doing so, plainly *strengthened* the standard that the Second Circuit had applied under Rule 9(b). 15

U.S.C. § 78u-4(b)(2) (emphasis added). Beyond that, the "Reform Act . . . makes *no* express mention of the motive and opportunity test developed in the Second Circuit, and certainly does not expressly codify it." *Bryant*, 187 F.3d at 1285 (emphasis added).

In short, even without resort to legislative history, Congress's choice of language in establishing the PSLRA's pleading standard makes clear its intent to create a pleading standard higher than any standard previously applied under Rule 9(b).

B. The legislative history makes clear that Congress was establishing a pleading standard more stringent than any that existed under Rule 9(b).

The legislative history of the PSLRA confirms that Congress intended to establish a pleading standard that was stricter than that applied by the Second Circuit or any other court. The bill reported by the Senate Banking Committee, S. 240, contained language similar to that ultimately adopted, but instead of using the word "particularity," provided that a "complaint shall . . . *specifically* allege facts giving rise to a strong inference that the defendant acted with the required state of mind." S. 240, 104th Cong. § 104(b) (as reported by S. Comm. on Banking, Housing and Urban Affairs, June 19, 1995; emphasis added). The Senate report explained that the bill was based partially, but not entirely, upon the Second Circuit's Rule 9(b) standards. The committee explained that the bill "does not adopt a new and untested pleading standard," and instead creates a "a uniform standard modeled upon the pleading standard of the Second Circuit[,] [r]egarded as the most stringent pleading standard." Nevertheless, the committee emphasized that it "does not intend to codify the Second Circuit's

caselaw interpreting this pleading standard." S. REP. NO. 104-98, at 15 (1995).

During the Senate floor debate on S. 240, Senator Specter proposed an amendment that set forth the "motive and opportunity" test and other language from the Second Circuit's cases. Senator Specter argued that, if the part of the Second Circuit's case law that was tough on plaintiffs should be included, then, in fairness, so should the part that accommodated them:

> This is just basic fundamental fairness that if you take the second circuit standard, you ought to take the entire standard, which is very tough on plaintiffs to establish state of mind, which is hard to prove.

141 CONG. REC. S9200 (daily ed. June 28, 1995) (statement of Sen. Specter). Senator Specter's amendment passed and became part of the bill that went to the Conference Committee. S. 240, 104th Cong. § 104(b), 141 CONG. REC. S9219, S9222 (as passed by the Senate, June 28, 1995). The Senate bill that went to the Conference Committee thus provided that "a strong inference that the defendant acted with the required state of mind may be established . . . by alleging facts to show that the defendant had both motive and opportunity to commit fraud." *Id.*

The conferees, however, deleted the Specter amendment, explaining that the proposed pleading requirement in the final bill was only "based *in part* on the pleading standard of the Second Circuit." H.R. CONF. REP. 104-369, at 41 (1995) (emphasis added). And the conferees made clear that the intent was to toughen existing pleading standards: "Because the Conference Committee intends to *strengthen* existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard." *Id.* (emphasis added). In

a direct reference to the Specter amendment, moreover, the Committee went on to explain that, "[f]or this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive [and] opportunity . . . ." *Id.* at 41 n.23 (emphasis added). This explanation clearly states Congressional intent. *E.g.*, *Garcia* v. *United States*, 469 U.S. 70, 76 (1984) (conference reports are the best authoritative source of legislative intent).

So, too, did the President understand that this was what Congress intended when he vetoed the PSLRA. In his message to Congress, President Clinton explained that he was returning the legislation *precisely because* Congress had made "crystal clear . . . [its] intent to raise the [pleading] standard *even beyond*" that of the Second Circuit, and "to erect a *higher* barrier to bringing suit than any now existing":

> I am prepared to support the high pleading standard of the U.S. Court of Appeals for the Second Circuit—the highest pleading standard of any Federal circuit court. *But the conferees make crystal clear in the Statement of Managers their intent to raise the standard even beyond that level. I am not prepared to accept that.*
>
> The conferees deleted an amendment offered by Senator Specter and adopted by the Senate that specifically incorporated Second Circuit case law with respect to pleading a claim of fraud. Then they specifically indicated that they were not adopting Second Circuit case law but instead intended to "strengthen" the existing pleading requirements of the Second Circuit. *All this shows that the conferees meant to erect a higher barrier to bringing suit than any now existing . . . .*

Private Securities Litigation Reform Act of 1995—Veto Message from the President of the United States, H.R. DOC. NO. 104-150 (emphasis added), *reprinted in* 141 CONG. REC. H15214-15 (daily ed. Dec. 20, 1995).[7]

In short, the history of the enactment of the PSLRA confirms what a comparison of the statute's language to prior case law makes clear: that Congress plainly intended to establish a securities fraud pleading standard that was stricter than any that had ever been applied before.

II. THE SEVENTH CIRCUIT'S DECISION IS INCONSISTENT WITH THE PSLRA'S LANGUAGE AND PURPOSE.

The pleading standard applied by the Seventh Circuit in this case clearly contradicts both the language and the purpose of the PSLRA. The Seventh Circuit held that a securities fraud complaint must be sustained "if it alleges facts from which, if true, a reasonable person *could* infer that the defendant acted with the required intent." Pet. App. 20a (emphasis added). Under this standard, a district court must uphold any complaint that raises any "reasonable," though not "strong," inference of scienter, and cannot consider whether an inference of a defendant's innocence was as plausible as, or more plausible than, an inference of culpability. That standard, however, amounts to little more than notice pleading, and does not come close to requiring a "strong inference" of scienter. Congress intended to raise the bar to securities fraud claims; the Seventh Circuit's "reasonable inference" standard would lower the bar, even below standards prevailing before the PSLRA.

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[7] Congress overrode the President's veto. 141 CONG. REC. D1511 (daily ed. Dec. 22, 1995).

A. Determination of what constitutes a "strong inference" necessarily requires weighing competing inferences.

Even apart from the historical backdrop of the PSLRA pleading standard, the Seventh Circuit's decision cannot be reconciled with the plain meaning of "strong inference." Not every inference that "*could*" be drawn is strong; a *strong* inference is one that overcomes other possible inferences. "Strong," in a logical sense, means "striking or *superior of its kind*: capable of making a clear or deep impression esp. on the mind or imagination." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 2265 (1986) (emphasis added). In the context "[o]f argument, evidence, [and] proof," it means "[p]owerful to demonstrate or convince; *hard to confute or overthrow*." 16 OXFORD ENGLISH DICTIONARY 949 (2d ed. 1989) (emphasis added).[8]

A *strong* inference, then, is one that is superior to other inferences, is hard to confute, and thus can endure or withstand challenges from other inferences. Assessing whether an inference of fraudulent intent is strong *necessarily* entails precisely what the Seventh Circuit abjured: a reasoned conclusion as to whether that inference is powerful enough to overcome other, more innocent inferences. And it makes no sense to say, as the Seventh Circuit seems to have concluded, that a given set of pleaded facts could simultaneously give rise to *strong* inferences of *both* innocence and guilt.

In light of its plain language, a plurality of circuits have interpreted the PSLRA's strong inference requirement to mean that "plaintiffs are entitled only to the

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[8] *See also* BLACK'S LAW DICTIONARY 1463 (8th ed. 2004) (defining "strongly corroborated" as evidence that is "powerful, satisfactory, and clear").

most plausible of competing inferences." *Helwig* v. *Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (en banc); *accord, e.g., In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2005) ("Scienter allegations do not pass the 'strong inference' test when . . . there are legitimate explanations for the behavior that are equally convincing."); *Ottman* v. *Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 350 (4th Cir. 2003) (finding no "strong inference" of scienter where alleged misstatement "was just as likely the result of an overgeneralization as it was the product of intentional deception or recklessness"); *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002) (holding that consideration of an "equally if not more plausible" inference of innocence "clearly impedes the plaintiffs' progress toward building the requisite strong inference of scienter").

The Seventh Circuit's "could infer" standard is, at the very least, a retreat to the weaker standard previously applied under Rule 9(b). And it is so vague that it threatens to revive the discredited approach of pleading "fraud by hindsight." A fraud-by-hindsight complaint typically "records statements by defendants predicting a prosperous future and holds them up against the backdrop of what actually transpired." *Shields* v. *Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1129 (2d Cir. 1994). As Judge Easterbrook put it:

> The story . . . is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud.

DiLeo v. *Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990).

One inference that *could* be drawn from this fact pattern may be described as

> [t]he 'hindsight' [of] inferring, from later poor performance, earlier knowledge that such later performance was likely,

or

> [t]he 'hindsight' [of] inferring, from a later [event], earlier knowledge that such [an event] was likely.

Greenstone v. *Cambex Corp.*, 975 F.2d at 25-26 (Breyer, Ch. J.). But even before the PSLRA, such an inference could not save a complaint from dismissal. As then-Chief Judge Breyer, applying the First Circuit's pre-PSLRA standard, explained:

> Were the law otherwise, a complaint could evade too easily the "particularity" requirement in Rule 9(b)'s first sentence. Suppose, for example, that in 1991 a corporation projects substantial revenues in the upcoming year. Suppose the corporation's actual 1992 sales are 50% less than predicted. To permit a securities fraud complaint to state, without more, that the corporation's executives "knew" in 1991 about the likely decline in 1992 sales would sanction what Judge Friendly called 'fraud by hindsight," *Denny* v. *Barber*, 576 F.2d 465, 470 (2d Cir. 1978), a practice that courts have not allowed.

Id. at 25.

Courts did not allow this practice because it "would too easily allow the inference that ordinary business reverses are fraud." *DiLeo*, 901 F.2d at 629. The "fraud-by-hindsight" cases implicitly weighed inferences, and they rejected inferences of fraud that were too weak to overcome inferences that the business reversal reflected events that either had not happened or whose signifi-

cance was not understood at the time of the allegedly fraudulent announcements. In adopting the PSLRA, Congress mandated even greater scrutiny of securities fraud complaints. To conclude that a court may not weigh competing inferences under the PSLRA thus ignores both logic and history.

B. The Seventh Circuit's standard would defeat the paramount congressional purpose of curbing frivolous and costly litigation.

This Court has long recognized the unique "danger of vexatiousness" presented by securities fraud class actions. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739 (1975). "[T]o the extent that [a securities fraud case] permits a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, . . . it is a social cost rather than a benefit." *Id.* at 741. The settlement value of such a case, even a case "which by objective standards may have very little chance of success at trial," is greatly enhanced if plaintiff can "prevent the suit from being resolved against him by dismissal." *Id.* at 740-41.

Similar concern with securities fraud class action abuses prompted Congress to enact the PSLRA. *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Dabit*, 126 S. Ct. 1503, 1510-11 (2006). The conference report on the bill decried "the abuse of the discovery process to impose costs so burdensome that it is often economical . . . to settle" and "the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer." H.R. CONF. REP. NO. 104-369, at 31 (1995). These lawsuits, the conference report said, were a national menace: "the entire U.S. economy ha[s] been injured by the unwillingness of

the best qualified persons to serve on boards of directors . . . because of fear of baseless and extortionate securities lawsuits." *Id.* at 31-32. "The fact that many of these lawsuits are filed as class actions has had an in terrorem effect on Corporate America," the Senate Banking Committee observed. S. REP. NO. 104-98, at 9 (1995). "These lawsuits have added significantly to the cost of raising capital and represent a 'litigation tax' on business." *Id.* (footnote omitted).

The social cost of securities fraud class actions has been growing, both nationally and regionally, since the PSLRA's passage in 1995. For example, contrary to Congress's intent in enacting the PSLRA to help ensure that "capital formation and investment may grow for the benefit of all Americans," *id.* at 31, private securities litigation is discouraging capital formation and investment in American markets. As the bipartisan Committee on Capital Markets Regulation recently observed, the data show that it is "undeniable" that the size of securities class-action settlements has been "soaring."[9] As a consequence, the cost of directors' and officers' insurance for American companies is more than six times what it is for their European counterparts.[10] This is highly detrimental to capital formation in the United States, because "[a]s average settlement values climb, so do the incentives for companies to try to evade private litigation under the U.S. securities laws by simply choosing to sell their shares elsewhere."[11]

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[9] COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 75 (Nov. 30, 2006), *available at* http://www.capmktsreg.org/pdfs/11.30 Committee_Interim_ReportREV2.pdf. The Committee, which U.S. Treasury Secretary Henry Paulson has endorsed, is composed of 22 corporate and financial leaders from business, finance, law, accounting, and academia.

[10] *Id.* at 78.

[11] *Id.*

Similarly, a recent report issued by New York City Mayor Michael Bloomberg and Senator Charles E. Schumer compiles evidence showing that businesses and investors are responding to these incentives: "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of business—and driven away potential investors."[12] The report, for example, details how, in the view of executives in the financial services sector, "New York City is seen as being significantly behind London" in "the quality of the legal system," and notes that "America's general propensity for litigation [is] the biggest driver behind New York City's problems in this area."[13] The report also remarks how "2005 [not only] set a new record for the highest-ever number of securities class-action settlements," but how "the overall value of these settlements overshadowed every prior year," with "the securities industry [bearing] a disproportionate share of the overall cost."[14] That is one reason why, from 2002 to 2005, "London's financial services workforce expanded by 4.3 percent," while "New York City's financial services employment fell by 0.7 percent."[15]

Technology, biotech, and other high-growth industries are also hard hit by securities fraud class actions.

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[12] MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP ii (Jan. 22, 2007), *available at* http://www.nyc.gov/html/om/pdf/ny_report_final.pdf.

[13] *Id.* at 73; *see also id.* at 73, 75 ("[T]he American [litigation] environment [is] seen as expensive and unpredictable" as compared to London's"; "85 percent [of CEOs surveyed] indicated that London['s legal environment] was preferable, and not a single one chose New York.").

[14] *Id.* at 74.

[15] *Id.* at 64.

"[B]ecause of the volatility of their stock prices," such companies "are particularly vulnerable to securities fraud lawsuits when projections do not materialize. If a company fails to satisfy its announced earnings projections . . . the company is likely to face a lawsuit." H.R. CONF. REP. NO. 104-369, at 43; *see also* H.R. REP. NO. 104-50, at 15-16 (Feb. 24, 1995) (describing high technology companies as "easy prey for plaintiffs' lawyers who want to file speculative suits"). As a result, at the time of the PSLRA's passage, some directors' and officers' insurance carriers had simply "stopped writing policies for companies in . . . the technology sector." S. REP. NO. 104-98, at 21. The sector remains vulnerable today, experiencing the second highest rate of such filings of any industry in 2006. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS: 2006, at 17 (2007), *available at* http://securities.stanford.edu/clearinghouse_research/2006_YIR/20070102-01.pdf.[16]

There is also a growing recognition that securities fraud class actions do not appropriately compensate defrauded investors, particularly diversified investors. Diversified investors hold a majority of the shares traded on public securities markets.[17] These investors—who are

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[16] As defined in the Cornerstone report, the technology sector includes "computers, office/business equipment, semiconductors, and software." *Id.* at 17 n.11. The "communications" sector—which includes most Internet-related companies—was tied for third most securities class action filings in 2006. *Id.* at 17.

[17] The proportion of shares held by institutional investors—including pension funds, mutual funds, and insurance companies—has been increasing for decades. Such investors, which are typically diversified, held 61.3% of outstanding equity securities by 2001. LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 729-30 (5th ed. 2004). Most retail investors also diversify. John C. Coffee, Jr., *Reforming the Securities Class Action*, 106 COLUM. L. REV. 1534, 1559 & nn.91 & 92 (2006).

just as likely to own shares of companies forced to pay securities fraud settlements as to be class members who benefit from such settlements—"are made worse off by securities litigation, because settlements from such lawsuits provide money to plaintiffs' left hand pocket by taking it from their right-hand pocket, with a substantial commission to the plaintiffs' attorneys for facilitating the transaction." Hearing before the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (June 28, 2006) (statement of Theodore H. Frank), *available at* 2006 WL 1789362.[18] Thus, while securities fraud litigation undoubtedly shifts resources to the professional plaintiffs' bar, it does not rationally compensate defrauded investors.

If permitted to stand, the Seventh Circuit's "reasonable inference" standard thus would exacerbate the social costs of securities litigation with no offsetting benefits to investors or the public. The standard is a step backward, one that frustrates efforts to adjust the securities laws to the needs of the national securities markets.

III. THE "REASONABLE INFERENCE" STANDARD IS NOT COMPELLED BY THE SEVENTH AMENDMENT.

The Seventh Circuit did not look to statutory language, purposes or history to justify the "reasonable inference" standard. Rather, the court expressed concern that a stricter standard "could potentially infringe upon

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[18] *See also* Neil Weinberg, *Cui Bono?*, FORBES, April 25, 2005, at 40 (calculating that the New York Common Retirement Fund, lead plaintiff in the WorldCom class action, would recover *less* in the $6 billion settlement than its pro rata share, based on its current equity holdings, of the losses incurred by the settling banks).

plaintiffs' Seventh Amendment rights." Pet. App. 20a. The Seventh Amendment, however, provides no reason to misread the "strong inference" standard as one requiring merely a plausible inference. As this Court made clear in *Parklane Hosiery Co., Inc.* v. *Shore*, 439 U.S 322 (1979), the Seventh Amendment "has never been interpreted in a rigid manner," and "the Amendment was designed to preserve the basic institution of jury trial in only its most fundamental elements, not the great mass of procedural forms and details, varying even then so widely among common-law jurisdictions." *Id.* at 336-37 (*quoting Galloway* v. *United States*, 319 U.S. 372, 392 (1943)). As this Court held long ago, moreover, "[t]he Seventh Amendment . . . does not attempt to regulate matters of pleading or practice." *Walker* v. *New Mexico & S. Pac. R.R. Co.*, 165 U.S. 593, 596 (1897); *see also United Air Lines, Inc.* v. *Wiener*, 335 F.2d 379, 406-07 (9th Cir. 1964) (same).

The PSLRA's specification of the pleading standard for securities fraud class actions can hardly be said to threaten the "basic institution of jury trial." Indeed, this Court has consistently upheld procedural innovations that far more closely relate to a jury's function than does the PSLRA pleading standard. It has held, for example, that the directed verdict does not violate the Seventh Amendment. *Galloway*, 319 U.S. at 388-93. It has held that a retrial limited to the question of damages does not violate the Seventh Amendment, even though there was no practice at common law for setting aside a verdict in part. *Gasoline Products Co.* v. *Champlin Refining Co.*, 283 U.S. 494, 497-98 (1931). And it has held that summary judgment does not violate the Seventh Amendment. *Fidelity & Deposit Co.* v. *United States*, 187 U.S. 315, 319-21 (1902).

Even where the *evidence*—as opposed to a pleading—is ambiguous, this Court has approved granting both summary judgment and directed verdict, thus taking the case away from the jury, without any suggestion that the Seventh Amendment was implicated:

- In *Matsushita Electric Industrial Co., Ltd.* v. *Zenith Radio Corp.*, this Court held, in a case under Section 1 of the Sherman Act, that "conduct *as consistent with* permissible competition as with illegal conspiracy does not, standing alone, support an inference of antitrust conspiracy." 475 U.S. 574, 588 (1986). The Court explained that summary judgment was appropriate even "if petitioners had had *a plausible reason* to conspire," because "*ambiguous* conduct" could not "suffice to create a triable issue of conspiracy." *Id.* at 588 n.21 (emphasis added).
- In *Pennsylvania Rail Co.* v. *Chamberlain*, which the Court described as "belonging to that class of cases where proven facts give equal support to each of two inconsistent inferences," the court upheld a grant of judgment as a matter of law "against the party upon whom rests the necessity of sustaining one of these inferences." 288 U.S. 333, 339 (1933).
- In *Gunning* v. *Cooley*, the Court stated that "[w]hen a plaintiff produces evidence that is consistent with an hypothesis that the defendant is not negligent, and also with one that he is, his proof tends to establish neither" and thus "the court should give a peremptory instruction to the jury." 281 U.S. 90, 95 (1930).

Such weighing of evidence at the summary judgment or directed verdict stage is inherently more invasive of the

jury's fact-finding role than at the pleading stage, in which all of plaintiffs' factual allegations are assumed to be true.

The Seventh Circuit ignored these cases. Its assertion about the Seventh Amendment was supported by no authority beyond a citation to dictum in *City of Monroe Employees Retirement System* v. *Bridgestone Corp.*, 399 F.3d 651, 683 n.25 (6th Cir. 2005). Pet. App. 20a. But that case *applied* the "most plausible inference" test. Its discussion of the Seventh Amendment cited only *SEC* v. *Infinity Group Co.*, 212 F.3d 180, 196 (3d Cir. 2000). That case—which upheld, on timeliness grounds, a denial of the defendants' request for a jury trial—said nothing to suggest that strengthening pleading standards implicated the Seventh Amendment.

CONCLUSION

The Seventh Circuit's "reasonable inference" standard is contrary to statutory language, legislative history and congressional purpose, and is not necessary to protect rights under the Seventh Amendment. The judgment of the Court of Appeals should be reversed.

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No. 06-484

In the Supreme Court of the United States

TELLABS, INC., et al.,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., et al.,

Respondents.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

BRIEF FOR OHIO AND 23 OTHER STATES, TERRITORIES AND COMMONWEALTHS AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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INTRODUCTION

Petitioners, Tellabs, Inc., et al. ("Tellabs"), advances an unreasonably high pleading standard for scienter that results in unbalancing the scales of justice in securities litigation. The unreasonably high standard carries the high price of blocking many meritorious claims of securities fraud that protect the market, well-run businesses, and investors.

Tellabs justifies the high pleading standard because of its stated fear of "strike suits," which, in its view, prompt otherwise profit-maximizing corporations to settle "even meritless claims for substantial sums." *Id.* at 16. See Tellabs Brief at 2, 16, 24, 27, 41 (referring to "strike suits" as Congress' overriding concern in changing securities fraud pleading requirements) and at 16 (asserting, without citation, that corporate defendants have "too often" been "forced" to settle those suits for "substantial sums").[1] As a result, Tellabs supports an unacceptable reading of the Private Securities Litigation Reform Act of 1995 ("PSLRA") that would empower judges—not juries—to assess the plausibility of every allegation of scienter and studiously ignore every allegation of "ambiguous conduct." *Id.* at 37, 41.

But Tellabs forgets the other pan on the scales—protecting investors, business, and the market from fraud. Whatever else may be said about their proposed standard, this much is certain: if it is accepted, meritorious complaints will be dismissed along with frivolous ones; fraud on the market will increase; and state pension funds, state employees, and state taxpayers will suffer.

The amici States urge the Court to adopt the balanced approach intended by Congress and used by the Seventh Circuit—a standard for pleading scienter higher than that for ordinary fraud, but not so high that even complaints based on reasonable inferences are dismissed without discovery.

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[1] Tellabs does not, however, contend that this suit is a "strike suit."

INTEREST OF THE AMICI STATES

Long before the SEC existed, the States provided their citizens with the earliest protection from securities fraud through the so-called "blue-sky" laws. Though state securities laws affording private civil remedies are now partly preempted, the States retain an interest in protecting their citizens from securities fraud. In this case the amici States see the potential for an unacceptable erosion of the rights of investors. In the absence of that protection, the amici States have a heightened interest in protecting their citizens from the unscrupulous actions of fraudulent corporations and the erosion of investors' rights in the marketplace.

Moreover, many of the amici States' pension funds are valued institutional investors in the marketplace. Amici States have a direct stake in protecting the rights of these important institutional investors—as well as the retirement funds of their public employees—to pursue fraud in the marketplace through securities litigation. Tellabs's proposed pleading standard would discourage pension funds and other large public shareholders from pursuing meritorious claims and curtail the important market-oversight role they play.

SUMMARY OF ARGUMENT

Tellabs's proposed, unreasonably high standard for scienter in securities fraud suits will indiscriminately turn away both frivolous and meritorious claims. Adoption of this high standard will upset the PSLRA's carefully balanced standard. Institutional investors rarely, if ever, file frivolous lawsuits, and indeed the market and investors depend on institutional investors to keep the market honest by aggressively ensuring corporate accountability. Since the PSLRA was passed in 1995, large private institutional investors have filed far fewer lawsuits, leaving the large public institutional investors—primarily the state pension funds—to file the majority of securities lawsuits on behalf of

state employees' pensions. Tellabs's proposed heightened pleading standard will discourage, and in some cases prevent, the large public investors from filing non-frivolous securities lawsuits. Not only will this prevent State funds from protecting the pensions of State employees, but these large investors will no longer be performing their market-protection role.[2]

Maintaining that balance is even more important now that the States' role in the securities registration process has been restricted. Because of widespread fraud, the States were the first entities to pass "blue-sky" laws to protect citizens from fraudulent securities sales. After the stock market crash of 1929, the federal government took over the role of protecting investors by creating the SEC and passing the Securities Act of 1933 and the Securities Exchange Act of 1934. Traditionally, the federal authorities focused primarily on the national markets, while the States monitored local markets.

But in the 1990s, a rapid increase in the filing of securities-fraud complaints—many of which were perceived as nothing more than frivolous strike suits—led the federal government to enact the PSLRA in 1995 and the Securities Litigation Uniform Standards Act ("SLUSA") in 1998. The SLUSA preempted most private civil applications of the states' blue-sky laws,[3] and the PSLRA established the pleading standard for scienter at issue here. If the Court

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[2] The *amici* States recognize that state blue-sky laws are not preempted as to the state pension funds. 15 U.S.C. §78bb(f)(B). However, the majority of securities fraud claims are tried as large, multi-state cases, essentially requiring venue and jurisdiction in federal court.

[3] The preemptive effect of SLUSA is limited to class-action civil lawsuits by private investors. Individual civil actions and state agency enforcement of blue-sky laws remain viable under SLUSA. See, *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71; 126 S.Ct. 1503 at 1514 (2006). However, because many, if not most, civil securities actions are brought as class actions, SLUSA effectively prevents most private lawsuits originally brought under the state blue-sky laws.

adopts Tellabs' unreasonably high standard for scienter, the combination of these two laws will severely hamper the ability of individual and private institutional investors to protect themselves from fraudulent securities sales.

Many States and their citizens are still reeling from the effects of major corporate scandals, such as MCI WorldCom and Enron. Richard A. Oppel Jr., *Enron Traders on Grandma Millie and Making Out Like Bandits*, N.Y. Times, June 13, 2004 at D7. Meanwhile, private investors have been stripped of their ability to file civil class-action suits under state laws. If on the one hand Congress preempted the States from protecting their citizens by allowing private class-action suits, on the other hand Congress surely did not intend a standard for pleading scienter that left investors without any remedy. The Court must restore the balance by adopting the Seventh Circuit's evenhanded standard for pleading scienter.

ARGUMENT

A. The pleading standard advanced by Tellabs thwarts the carefully balanced purposes of the PSLRA—curbing frivolous complaints, but also encouraging meritorious claims—and effectively precludes the States' large investment funds from aggressively monitoring the market.

1. PSLRA was passed to curb frivolous complaints, but also to encourage meritorious claims.

The PSLRA was enacted not only to curb frivolous securities fraud complaints, but also to encourage meritorious ones. Julie Ann Sullivan, *The Science of Scienter: The Private Securities Litigation Reform Act's Effect and the Long-Awaited Decision of* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 1 Seventh Circuit Review 327 (2006) (PSLRA designed to curb frivolous litigation while retaining and increasing the value of meritorious claims); accord Jeffrey A. Berens, *Pleading Scienter Under the Private Securities*

Litigation Reform Act of 1995, Colo. Law., Feb. 2002, at 39, 40. Adopting the elevated scienter standard advanced by Tellabs would upset the balance by discouraging meritorious claims as well.

Tellabs seeks just that imbalance—they assert that a securities fraud complaint should be dismissed even when a *reasonable* person would infer that the defendants acted with scienter. Tellabs Brief, p. 37-41. But as the circuits have recognized, reasonable complaints are supposedly not targeted by the PSLRA and Civil Rule 12(b)(6). *Makor Issues & Rights v. Tellabs*, 437 F.3d 588, 601-02 (7th Cir. 2006); *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 354 (5th Cir. 2002); *Ronconi v. Larkin*, 253 F.3d 423, 428 (9th Cir. 2001). Rather, the circuits understand that the entire "welfare of victimized investors and the integrity of the stock market" necessarily depend on reasonable inferences getting to a jury. *Ronconi*, 253 F.3d at 428.

Moreover, Tellabs's standard would also upset the constitutional balance by asking the federal courts to rule on disputed questions of material fact at the pleading stage, thus raising a potential Seventh Amendment problem. See *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 683 n.25 (6th Cir. 2005) (recognizing the "Seventh Amendment problem" posed by its own "most plausible" inference standard); *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 437 F.3d 588, 602 (7th Cir. 2006) (rejecting Sixth Circuit's "most plausible" standard in favor of "an approach that cannot be misunderstood an a usurpation of the jury's

role.").[4]

2. The pleading standard advanced by Tellabs would severely damage one of the most powerful mechanisms for controlling fraud in the marketplace: legitimate securities lawsuits by large institutional investors such as the States' pension funds.

The legal standard proposed by Tellabs addresses only one side of the securities fraud balance—how to quickly dispose of the truly frivolous suit. But by requiring judges to quantify the "strength" of "inferences" based on nothing more than a complaint, those standards neglect the opposite side of the scale—how to ensure that legitimate suits are decided on their merits. A fraudulent marketplace favors bad companies and harms both business and investors. And legitimate suits are one of the strongest mechanisms for preventing fraud in the marketplace.

a. "Strike suits" are bad for business, but fraud is worse.

No one favors frivolous lawsuits, but securities fraud is increasing and extremely damaging to the marketplace. See Hillary A. Sale, *Judging Heuristics*, 35 U.C. Davis L. Rev. 903, 958 (2002). As one scholar put it, "fraud is very, very bad for securities markets" because it erodes investor confidence:

> [F]raud is bad for securities markets because it erodes investor confidence. [F]raud makes it difficult for

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[4] See also *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1101 (10th Cir. 2003) ("The PSLRA did not, however, purport to move up the trial to the pleading stage."); *Pirraglia v. Novell*, 339 F.3d 1182, 1188 (10th cir. 2003) ("[I]t is inappropriate for us to make a determination as to which inference will ultimately prevail, lest we invade the traditional role of the factfinder."); *Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 666 (8th Cir. 2001) ("The strong inference pleading standard does not license us to resolve disputed facts at this stage of the case.").

> investors to detect differences in the quality of the securities they buy. Companies issuing bad securities—poorly run firms that throw away money and do a poor job for their investors—can sell their securities at about the same price as well-managed firms, because fraud makes it impossible for investors to easily distinguish between high-quality and low-quality firms.

Lynn Stout, *Symposium: Securities Litigation: The Fundamental Issues*, 38 Ariz. L. Rev. 711, 713 (1996). Thus, bad companies flourish in a fraudulent market, and good companies flounder:

> What happens in such a market? Very quickly the market gets flooded with bad firms, because fraud allows them to sell worthless securities at high prices. Until, of course, investors learn that they can't distinguish between good and bad companies [and] begin to discount the quality of all the securities in the market. In other words, they lose confidence in the market, and will no longer pay high prices even to good firms selling quality securities. [G]ood firms exit the market, because they can't get a decent price for their securities.

Id. Frivolous suits may raise the cost of doing business, but the courts are well designed to dispose of such cases. On the other hand, rampant undetected fraud destroys the whole market. Tellabs's high scienter standard threatens all investors and all business because it discourages legitimate lawsuits and thus leaves the market open to even more fraud.

b. Under the Seventh Circuit's pleading standard, institutional investors, such as the States' pension funds, have balanced incentives: strong economic incentives to litigate meritorious claims and equally strong economic disincentives to pursue "strike suits."

The PSLRA is designed to favor institutional investors and protects public companies from strike suits. In fact, the market operates on the presumption that the investor with the "largest financial interest" at stake will be the most suitable lead plaintiff, precisely because large investors are likely both to "faithfully and diligently represent" the class of stockholders and to effectively "monitor" their counsel. Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2095, 2099 (1995).[5] Institutional funds rarely file suits deemed "frivolous." But, because of their size, they "almost always" file suits when they sustain large losses that are attributable to fraud. *Id.* at 2091.

Moreover, in the eleven years since the PSLRA's enactment, public institutional investors have served as lead plaintiffs in securities class actions considerably more often than "private institutional investors, such as mutual funds, banks and insurance companies." Stephen J. Choi & Robert B. Thompson, *Symposium: Litigation Reform Since the PSLRA: A Ten-Year Retrospective*, 106 Colum. L. Rev. 1489, 1504 (2006). For example, currently, at least six of Ohio's public pension funds are serving as lead plaintiff or co-lead plaintiff in large, private securities class actions pending in federal court. *In re Exxon Mobil Sec. Litig.*, Case No. 04-1257, filed Mar. 17, 2004 (D.N.J.) (lead plaintiffs are Ohio Public Employees Retirement System ("OPERS") and State Teachers Retirement System of Ohio ("STRS Ohio")); *Ohio Public Employees Ret. Sys. v. Fannie Mae*, Case No. 2:04cv1106, filed Nov. 22, 2004 (S.D. Ohio) (lead plaintiffs are OPERS, STRS Ohio, and Ohio Bureau of Workers

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[5] This article was "the impetus behind Congress's focus on institutional investors." See Stephen J. Choi & Robert B. Thompson, *Symposium: Litigation Reform Since the PSLRA: A Ten-Year Retrospective*, 106 Colum. L. Rev. 1489, p. 1503 n. 90 (2006).

Compensation ("BWC")); *In re American International Group, Inc., Sec. Litig.*, Case No. 04-8141, filed Oct. 15, 2004 (S.D.N.Y.) (lead plaintiffs are OPERS, STRS Ohio, and Ohio Police & Fire Pension Fund ("OPFP")); *In re Global Crossing Ltd., Sec. Litig.*, Case No. 02 Civ 910, filed Jan. 28, 2003 (S.D.N.Y.) (lead plaintiffs are OPERS and STRS Ohio); *In re Marsh & McLennan Cos., Inc., Sec. Litig.*, MDL 1744, Case No. 1:04-cv-8144, filed Oct. 15, 2004 (S.D.N.Y.) (lead plaintiffs are OPERS and STRS Ohio); *In re Pilgrim Baxter Sec. Litig.*, (part of *In re Mutual Funds Investment Litig.*, MDL 1586), Case No. 04-md-01151, filed May 3, 2004 (D. Md.) (lead plaintiff is Ohio Public Employees Deferred Compensation Plan ("OPEDCP")); *Saunders v. Putnam American Government Income Fund* (part of *In re Mutual Funds Investment Litig.*, MDL 1586), Case No. 04-md-560, filed Mar. 5, 2004 (D.Md.) (lead plaintiff is Ohio Tuition Trust Authority ("OTTA")); *In re Scottish Re Group Ltd. Sec. Litig.*, Case No. 1:06cv5853, filed Aug. 2, 2006 (S.D.N.Y.) (lead plaintiff is STRS Ohio); *In re UnitedHealth Group, Inc. Shareholder Deriv. Litig.*, Case No. 0:06-cv-1216, filed Mar. 29, 2006 (D. Minn.) (OPERS and STRS of Ohio are co-lead plaintiffs).

Indeed, these state funds willingly litigate to protect their members' retirements, whereas the private funds do not. Private funds are discouraged from filing because it takes time and resources away from income-producing activities, may expose secret investment information, and results in a small benefit to the lead plaintiff. Choi & Thompson at 1504-05. Public funds, which do not have the same secrecy and income concerns, are more likely to bring fraud suits to protect state employee pensions. Additionally, public funds as lead plaintiffs protect the individual investor from fraud.

Thus, the state funds have become the primary check on securities fraud in the marketplace. Tellabs's proposed pleading standard will upset the incentive balance. State pension funds will be discouraged from filing legitimate

market-sanitizing lawsuits, and it will be much more likely that legitimate lawsuits will be dismissed even if they are filed.

B. The Court should reject Tellabs's pleading standard because Congress intended the SEC to protect private investors after having stripped them of some State remedies in this area.

The States traditionally have played a leading role in protecting citizens from fraudulent securities transactions. Indeed, the States preceded the federal government in regulating the securities industry by roughly twenty years, enacting the first comprehensive securities-fraud-prevention statutes as early as 1911. See Joseph C. Long, *Blue-sky Law Handbook: Developments in State Securities Regulation* § 1.01 (1985). These statutes were given the name "blue-sky laws" because they were reportedly "aimed at promoters who 'would sell building lots in the blue-sky in fee simple,'" 1 Louis Loss & Joel Seligman, *Securities Regulation* § 1-B-1 (3d ed. 1989) (quoting Thomas Mulvey, *Blue-sky Law*, 36 Can. L. Times 37 (1916)). As the country's first consumer protection laws, they were precipitated by "intermittent securities fraud waves" that swept across the U.S. securities industry in the first few decades of the twentieth century. See Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. Corp. L. 1, 18 (1983).

The federal government began to play a role in the area of investor and market protection only after the 1929 stock market crash. At first, the state and federal laws and regulators worked in tandem to protect both the market and investors from the adverse effects of fraud. Richard H. Walker, *Evaluating the Preemption Evidence: Have the Proponents Met Their Burden?*, 60 Contemp. Prob. 237 (Summer 1997). But in the 1990s, in response to a perceived increase in frivolous lawsuits, Congress made fraud suits harder to plead and litigate, and also preempted private class-

action applications of the state blue-sky laws. *Id.* With the passage of the PSLRA and SLUSA, Congress gave the SEC a significantly greater role in the protection of investors.

The States are alarmed by this case because Tellabs and the SEC are advocating a pleading standard so high that investors will be prevented from bringing most fraud suits. If that happens, the investor rights so carefully protected by the States for so many decades are in grave danger. And if investors are not protected from fraud, the market could return to the days when fraudulent promoters were the norm and not the exception.

In passing the PSLRA and SLUSA, Congress did not intend such a result, but intended instead a balance between discouraging frivolous suits and prevention of fraud. The States urge this Court to interpret the pleading standard in light of the balance Congress intended.

1. In response to rampant fraud in the securities industry, the States were first to protect citizen investors by passing "blue-sky" laws.cey

The securities industry in the early twentieth century engaged in a number of questionable practices. The 1900s and 1910s saw an unprecedented rise in sales of highly speculative securities to individuals with little prior experience in the stock market—usually farmers. Thomas Mulvey, *Blue-sky Law*, 36 Can. L. Times 37, 37 (1916). High-risk stocks were often sold by newspaper advertisements or mailing lists (deemed "sucker lists") that made extravagant claims about the virtues of the company selling the stock. See Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue-sky Laws*, 70 Tex. L. Rev. 347, 353-59 (December, 1991). Many farmers lost thousands in savings and mortgaged their farms on bad investments. See *id.* at 354 n.31.

A 1904 congressional report identified "secrecy and dishonesty in promotion," "secrecy of corporation administration," and "misleading or dishonest financial statements." See Seligman at 19 (quoting Report of the Comm'r of Corporations, H.R. Doc. No. 165, 58th Cong., 3d Sess. 30 (1904)). Corporate insiders also frequently engaged in stock "watering," or issuing stock in amounts far exceeding the value of the underlying assets. *Id.* (noting existence of at least 79 reported stock-watering cases between 1897 and 1910). See also *Old Dominion Mining and Smelting Company v. Lewisohn*, 210 U.S. 206, 210-11 (1908) (self-dealing in sale of mining property stock). *Id.* [6]

A second wave of securities fraud occurred in the 1920s, following World War I. 1-1 *Ohio Securities Law & Practice* § 1.02 (2005). Securities promoters obtained lists of Liberty Bond purchasers, who then became targets of predatory securities sales. *Id.* See also Gilbert E. Brach, *The Blue-sky Law*, 3 Marq. L. Rev. 142, 142 (1918-1919) (describing Liberty Bond purchasers as "easy prey, falling into the snare set by the wiles of the stock salesman"); Seligman, at 21 ("Beginning about the time of 1917 and 1918 Liberty Loan Sales campaigns, there was a noticeable increase in securities fraud, with many advertisements or salesmen successfully persuading purchasers of Liberty Bonds to exchange them for fraudulent securities.").

In response to these unscrupulous practices, the States passed laws to protect unsuspecting investors from fraud. Joseph C. Long, *Blue-sky Law Handbook* at 1-2. By first imposing registration and licensing requirements and later

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[6] A handful of contemporary academics have questioned the traditional account of the first wave of blue-sky laws as a response to market fraud. See Macey & Miller; Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J. Law & Econ. 229 (2003). However, the fraud-prevention explanation for the first wave of blue-sky laws continues to enjoy "nearly universal acceptance." See Macey & Miller at 349.

implementing additional antifraud provisions, the States sought to eliminate any securities that were not "fair, just, or equitable" to consumers. *Id.*

2. The federal government first regulated the securities industry only in the 1930s.

It was not until the stock market crash of 1929 and the ensuing depression that the federal government finally created a federal securities agency to deal with securities issues facing the nation at large. *Id.* Congress created the SEC, in the Securities Exchange Act of 1934, 15 U.S.C. § 78a, *et seq.* The SEC's mission was and is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." U.S. Securities Exchange Commission Website, www.sec.gov (February 27, 2007). Rather than displace state regulatory systems and state regulatory agencies that had been active for nearly two decades before the Exchange Act was passed, Congress specifically included a relatively broad savings clause preserving state-law rights and remedies. *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 96 (1987) Scalia, J. concurring, quoting 15 U.S.C. § 78bb(a). Thus, from 1934 to the early 1990s, the SEC often worked hand in hand with state regulators and prosecutors to satisfy its charge.

In the 1990s, in response to a perceived increase of frivolous strike suits and industry calls for deregulation, Congress passed two new laws that shifted the balance of state and federal regulation. Harold S. Bloomenthal, 2 *Securities Law Handbook* § 25.4 (2007); Manning Gilbert Warren III, *Federalism and Investor Protection: Constitutional Restraints on Preemption of State Remedies for Securities Fraud*, 60 Law & Contemp. Prob. 169 (Summer 1997); Erik Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 Conn. L. Rev. 393, 414 (Feb. 2006). The first law, PSLRA, was passed in 1995 and added a number of provisions to the

Exchange Act that make securities fraud claims more difficult to plead and litigate. 15 U.S.C. § 78u-4. The second law, SLUSA, was passed in 1998 and gave the federal courts exclusive jurisdiction over most fraud-based securities class actions. 15 U.S.C. § 78bb(f); see also *Manual for Complex Litigation* § 31.3 (2006). Before SLUSA, plaintiffs sought to avoid the more restrictive provisions of the PSLRA by basing their securities fraud complaints on less onerous state-law causes of action. Gerding at 414. Once SLUSA was enacted, however, state-law remedies and the state courts were no longer available for private class-action suits. *Id.*

3. The Court should preserve the balance created by Congress in the PSLRA and protect the interests of investing consumers.

"Any nation purporting to be governed by a rule of law must actually provide for mechanisms of enforcement against fraud and deception in its securities markets." Joseph Morrissey, *Catching the Culprits: Is Sarbanes-Oxley Enough?*, 2003 Colum. Bus. L. Rev. 801, 809 (2003). Market discipline exits because "[c]orporate officers could be sure that if their pronouncements to investors were in any way misleading, they would end up on the wrong end of a lawsuit." *Id.* at 810-811. The private securities lawsuit has functioned as a "crucial component of the effective functioning of the securities fraud laws." *Id.*

The amici States are alarmed by this case because not just Tellabs but the SEC—charged with protecting the States' investing consumers—urges the Court to adopt a pleading standard that will effectively preclude most securities fraud suits. U.S. Brief at 15-29. SEC's standard would eliminate the "crucial component" of the checks against fraud and leave investors unprotected.

Indeed, the SEC until recently has argued for a much lower standard—the standard articulated in a well-developed jurisprudence by the Second Circuit.[7] The Second Circuit standard states that the requisite "strong inference" may arise where the complaint contains particularized facts that indicate that the defendants 1) benefited in a concrete way from the purported fraud; 2) engaged in deliberately illegal behavior; 3) knew facts or had access to information suggesting that their public statements were not accurate or 4) failed to check information they had a duty to monitor. See *Novak v. Kansas*, 216 F.3d 300, 311 (2d Cir. 2000). In other words, the Second Circuit used a flexible standard that does not require judges to make a finding of fact before discovery.

However, in its Brief before this Court, the SEC changes tack and now argues for an unreasonably high standard similar to the one that Tellabs asserts.

Industry scholars and advocacy groups are voicing legitimate concern for consumers and the future of securities law because of SEC's new position. See, e.g., Jonathan Peterson, *Critics Fear SEC Chief Is Seeking To Limit*

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[7] The SEC filed briefs in a number of cases advocating that the scienter pleading standard articulated by the Second Circuit was adopted by Congress in the PSLRA. Those available on Westlaw are as follows: *Caprin v. Simon Transp. Servs.*, No. 01-4049, 2001 WL 34664973 (10th Cir. July 2, 2001); *In re K-Tel Int'l., Inc. Sec. Litig.*, No. 00-3210, 2000 WL 35483737 (8th Cir. Nov. 15, 2000); *Helwig v. Vencor, Inc.*, No. 99-5153, 2000 WL 34432856 (6th Cir. Aug. 18, 2000); *Weld v. Stage Stores, Inc.* No. 00-20230, 2000 WL 34032458 (5th Cir. June 2000); *Lone Star Ladies Inv. Club v. Schlotzky's, Inc.*, No. 99-50958, 1999 WL 33620099 (5th Cir. Dec. 28, 1999); *Nathenson v. Zonagen Inc.*, No. 99-20449, 1999 WL 33613893 (5th Cir. Sept. 30, 1999); *Greebel v. FTP Software, Inc.*, No. 98-2194, 1999 WL 33911562 (1st Cir. May 1999); *Bryant v. Avado Brands, Inc.*, No. 98-9253, 1999 WL 33631523 (11th Cir. Feb. 16, 1999); *In re Silicon Graphics Sec. Litig.*, No. 97-16240, 1997 WL 33551249 (9th Cir. Nov. 1997); *Zeid v. Kimberley*, No. 97-16070, 1997 WL 33555504 (9th Cir. Oct. 1997).

Investors' Ability To Sue: Cox Says He Wants To Prevent "Abusive Litigation." But Recent Events Raise Questions About His Intentions, L.A. Times, February 20, 2007, at C1 (characterizing current SEC Chairman Christopher Cox as "the fox guarding the henhouse."); Stephen Labaton, *SEC Seeks To Curtail Investor Suits*, N.Y. Times, February 13, 2007 at C1 ("Critics said that the moves signaled a major retrenchment from the post-Enron changes and showed that a lobbying push by big companies, Wall Street firms and the accounting industry was gaining traction as they seek to roll back what they see as onerous regulation and excessive investor litigation."); Wall Street Journal Online, Law Blog *The SEC: Peeling Back Post-Enron Investor Protections?*, http://blogs.wsj.com/law/2007/02/13/the-sec-peeling-back-post-enron-investor-protections/ (February 13, 2007) (former SEC chief accountant Lynn Turner commenting, "This administration and this agency are very pro-business and anti-investor.").

While amici States agree that an important aspect of securities regulation is the prevention of abusive litigation, that side of the scale must be balanced by also encouraging legitimate securities-fraud suits. This is especially true when insider-trading and other frauds are still being uncovered. For example, thirteen individuals were arrested just this month as part of a large insider trading ring. Carrie Johnson, *13 Charged In Big Insider Trading Scam: Plots Touch 4 Elite Wall Street Firms*, Washington Post, March 2, 2007, at A01. A New York grand jury has indicted nine of the participants on conspiracy, fraud, and bribery charges, including brokers and lawyers from top-tier Wall Street firms UBS, Morgan Stanley, Bank of America Securities, and Bear Stearns. *Id.* If not kept in check by the potential for investor suits, insider trading and other fraud will increase.

Without private class-action securities-fraud suits, the States' citizens are in danger of a return to the days of rampant fraud and distrust of the market. When investors are

forced into federal court only to have *reasonable* inferences of recklessness or malice dismissed, the system is seriously unbalanced. The Court should preserve the balance by adopting the Seventh Circuit's standard.

Amici States strongly oppose the Tellabs-SEC pleading standard because it destroys the balance of the scales of justice, threatens legitimate securities-fraud claims, and potentially infringes investors' Seventh Amendment rights.

CONCLUSION

For the foregoing reasons, amici States ask that the Court restore the balance by affirming the Seventh Circuit decision.

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March 09, 2007

No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED and RICHARD C. NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF OF THE NEW YORK STATE COMMON RETIREMENT FUND, THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM, THE STATE OF WISCONSIN INVESTMENT BOARD, THE LOS ANGELES COUNTY EMPLOYEES RETIREMENT ASSOCIATION, THE TEACHERS' RETIREMENT SYSTEM OF LOUISIANA, THE ARKANSAS TEACHER RETIREMENT SYSTEM, THE SACRAMENTO COUNTY EMPLOYEES' RETIREMENT SYSTEM, THE GOVERNMENT OF GUAM RETIREMENT FUND, THE LOUISIANA SHERIFFS PENSION & RELIEF FUND, THE JACKSONVILLE POLICE AND FIRE PENSION FUND AND THE ANCHORAGE POLICE AND FIRE RETIREMENT SYSTEM AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF AMICI[1]

The American Civil Liberties Union (ACLU) is a nationwide, nonprofit, nonpartisan organization with approximately 550,000 members dedicated to the principles of liberty and equality embodied in the Constitution and this nation's civil rights laws. The ACLU of Northern California is one of its regional affiliates. Since its founding in 1920, the ACLU has frequently appeared before this Court, both as direct counsel and as *amicus curiae*. In particular, the ACLU has participated in numerous cases addressing the proper scope of the Fourth Amendment.

The Asian American Legal Defense and Education Fund ("AALDEF"), founded in 1974, is a non-profit organization based in New York City. AALDEF defends the civil rights of Asian Americans nationwide through the prosecution of lawsuits, legal advocacy and dissemination of public information. AALDEF has throughout its long history defended and protected the civil liberties of Asian Americans and other minorities. The decision below creates the real possibility that police who stop and search vehicles on the basis of racial profiles will be able to circumvent the protections of the Fourth Amendment.

The National Association for the Advancement of Colored People ("NAACP"), established in 1909, is the nation's oldest civil rights organization. The fundamental mission of the NAACP is the advancement and improvement of the political, educational, social and economic status of

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[1] Letters of consent to the filing of this brief have been lodged with the Clerk of the Court pursuant to Rule 37.3. Pursuant to Rule 37.6, counsel for *amici* states that no counsel for a party authored this brief in whole or in part and no person, other than *amici*, its members or its counsel made a monetary contribution to the preparation or submission of this brief.

minority groups; the elimination of racial prejudice; the publicizing of adverse effects of discrimination; and the initiation of lawful action to secure the elimination of racial and ethnic bias. As part of that mission, the NAACP has vigorously opposed the use of racial profiling by law enforcement officials to target minority drivers and their passengers. *See, e.g.*, Dr. Dwight Steward & Dr. Douglas Berg, TEXAS STATE CONFERENCE OF NAACP BRANCHES RACIAL PROFILING STUDY: A STATISTICAL EXAMINATION OF RACIAL PROFILING (2000), *available at* http://www.texasnaacp.org/rp.doc. While eliminating racial profiling will require a multi-faceted effort, obtaining meaningful enforcement of the Fourth Amendment by the courts is an essential component to protecting our rights as citizens against unconstitutional stops, searches and seizures.

STATEMENT OF THE CASE

On November 27, 2001, at roughly 1:40 a.m., Sutter County Sheriff's Deputy Robert Charles Brokenbrough stopped a car being driven by Karen Simeroth. *People v. Brendlin*, 38 Cal. 4th 1107, 1111 (Cal. 2006). Earlier that evening, while in the parking lot of a Circle K market, Brokenbrough had noticed that the registration tag on the Buick was expired, but he was informed by dispatch that an application for renewal was "in process" and did not attempt to question the driver of the car or to effect a traffic stop at that time. *Id.* When he later saw the car on Franklin Road, Brokenbrough noticed a temporary operating permit on the car, consistent with the application for renewal, that did not expire until the end of the month. *Id.* He nevertheless pulled the car over for a traffic stop to see whether the temporary

operating permit affixed to the rear window matched the vehicle. *Id.*

In its brief before the California State Supreme Court, the State conceded that Brokenbrough had no reasonable articulable suspicion to stop the car, because "[a] vehicle with an application for renewal of expired registration would be expected to have a temporary operating permit." *Id.* at 1114. The traffic stop was thus unlawful. *Id.*

Bruce Brendlin was a passenger in Simeroth's car. *Id.* at 1111. After the vehicle was pulled over, both Simeroth and Brendlin were asked to identify themselves. *Id.* Because Brokenbrough recognized Brendlin and believed him to be a parolee at large, he contacted dispatch, which informed Brokenbrough that a "no bail" warrant had been issued for Brendlin's arrest. *Id.* Brokenbrough immediately ordered Brendlin out of the car at gunpoint and seized a syringe cap during a search incident to arrest. *Id.* at 1111-12. A subsequent search of the car uncovered various items related to the manufacture of methamphetamine. *Id.*

Brendlin was charged with multiple counts relating to the possession and manufacture of methamphetamine. *See* Petition for Writ of Certiorari at 4, *Brendlin v. California*, No. 06-8120 (U.S. Nov. 28, 2006). The trial court denied his motion to suppress, but the California Court of Appeal reversed, finding that, because Brendlin had been detained by the traffic stop within the meaning of the Fourth Amendment, he was entitled to have the evidence against him suppressed as the fruit of the unlawful stop. *Brendlin*, 38 Cal. 4th at 1112-13. The California Supreme Court disagreed. It held that because Brendlin was a passenger in the car and not the driver, he had not been seized by the traffic stop as a constitutional matter because he was "free to ignore the

police presence and go about his . . . business." *Id.* at 1117. Thus, even though the evidence against Brendlin would not have been uncovered but for the concededly illegal stop, and even though it was inadmissible against the driver, the court held that he was not entitled to suppression. *Id.* at 1123.

This Court granted certiorari to decide the following question: Whether a passenger in a vehicle subject to a traffic stop is thereby "detained" for purposes of the Fourth Amendment, thus allowing the passenger to contest the legality of the traffic stop. *Brendlin v. California*, 127 S. Ct. 1145 (2007).

SUMMARY OF ARGUMENT

The California Supreme Court's ruling that Brendlin was not seized by the traffic stop at issue is flawed in two pivotal ways. First, the lower court erroneously assumed that a reasonable person in Brendlin's situation would have felt free to leave the car when it was initially pulled over — a holding that defies common sense, not least because the stop had no reasonable or identifiable purpose. Second, contrary to this Court's unambiguous precedent, the California Supreme Court improperly relied upon the police officer's subjective intent in order to determine whether and when the seizure occurred.

Because Petitioner's Brief will discuss both of these issues in detail, *amici* will address them only briefly. Instead, this brief will focus upon the impact an affirmance of the lower court's ruling would have on arbitrary and illegal stops and searches based on race, *i.e.*, on the practice of racial profiling. The California Court's ruling threatens to leave

those subjected to racially suspect stops and searches without adequate and appropriate legal recourse.

It is uncontested that the stop to which Brendlin and Simeroth were subjected was unlawful; in fact, the stop was precisely the type of arbitrary and capricious exercise of police power the Fourth Amendment was intended to combat. Simeroth, the driver, has accordingly been free to seek vindication of her Fourth Amendment rights via suppression of the evidence discovered against her as a result of the unlawful stop. Brendlin, according to the California court, has no such recourse. This incongruous outcome — wherein drivers are afforded full Fourth Amendment protections but passengers none at all — results in a perverse police incentive to stop cars arbitrarily, and with impunity with respect to passengers, in the hopes of discovering evidence against a passenger that cannot be discovered by other means.

Statistical evidence of racial profiling indicates that minorities will be disproportionately affected by the ruling and the improper incentives it creates for law enforcement. Minorities throughout the United States are disproportionately stopped and searched despite the overwhelming data that shows the rates of contraband discovery and arrest are the same across racial groups. A ruling that fails to recognize the seizure of passengers even at the initiation of a traffic stop would thus make minorities doubly vulnerable — first, when they are disproportionately stopped and searched, and then again when they are left without a remedy under the Fourth Amendment even if a stop is based on race and race alone. The rule announced by the California court should be cause for concern for all passengers, who would be subjected to illegal stops without

Fourth Amendment protections, but would have particularly pernicious consequences for minority passengers.

ARGUMENT

I. THE STANDARD GOVERNING SEIZURE USED BY THE CALIFORNIA SUPREME COURT IS INCONSISTENT WITH THIS COURT'S FOURTH AMENDMENT JURISPRUDENCE.

A. Petitioner Was Seized By The Traffic Stop Because A Reasonable Person In His Circumstances Would Not Have Felt Free To Leave.

The California Supreme Court's premise that Brendlin "knew he was free to ignore the police presence and go about his business . . . even if he was unable as a practical matter to leave the scene until the car came to halt," 38 Cal. 4th at 1121, is inconsistent with the facts of this case, this Court's precedent, and realistic assessments about a reasonable passenger's perception of what he is permitted to do when subjected to a traffic stop.

According to the state supreme court, "[a]bsent some directive from the police, and as long as the rules of the road are otherwise obeyed, the passenger is free to do what the driver cannot — i.e., exit the vehicle . . . and thereby terminate the encounter with the officer." *Brendlin*, 38 Cal. 4th at 1120. Setting aside the myriad individual circumstances under which this proposition is arguably untrue — for example, when there is inclement weather, the stop is conducted late at night (as was the case here), or the stop is conducted on the side of a busy highway — it is plain that a reasonable person would ordinarily not believe that he is simply free to leave a car that has been pulled over by law

enforcement until there is some indication that this is the case.[2]

That is especially true when, as here, the stop is unsupported by any legitimate law enforcement purpose. Because Simeroth had not in fact been violating any traffic laws, neither Simeroth nor Brendlin had any reason to know why the car had been pulled over, and thus no way of knowing who or what the police were investigating. Under the circumstances, it was entirely reasonable for both to assume that they had been seized by the police and that neither was free to leave the car. The objective reasonableness of that perception was reinforced in this case when Brendlin was asked to identify himself as soon as the officer approached the car. *Brendlin*, 38 Cal. 4th at 111.[3]

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[2] This Court's decision in *Mendenhall* notes that her encounter with DEA agents at the airport might "reasonably have appeared coercive to the respondent, who was 22 years old and had not been graduated from high school. It is additionally suggested that the respondent, a female and a Negro, may have felt unusually threatened by the officers, who were white males." The Court goes on to acknowledge the relevance of those factors but concludes that the totality of the evidence in the case supported a finding of consent. *United States v. Mendenhall*, 446 U.S. 544, 558 (1980). It is difficult to imagine any conceivable traffic stop under which any reasonable passenger — much less a person of color, or a person without a college education, or a young woman pulled over by two male law enforcement officers — would feel free simply to walk away from the car without assurance from the police that doing so was acceptable.

[3] *Cf. Hiibel v. Sixth Judicial Dist. Ct. of Nev.*, 542 U.S. 177, 182-83 (2004) (identifying 21 states where a person may be subject to criminal penalty for refusing to identify himself to a police officer after a lawful stop).

This Court, moreover, has recently held that a passenger can be arrested based on contraband found in a stopped car, *Maryland v. Pringle*, 540 U.S. 366, 374 (2003), and that a passenger's personal effects are subject to search if there is probable cause to search the car, *Wyoming v. Houghton*, 526 U.S. 295, 307 (1999). The Court has justified these rulings on the ground that "a car passenger . . . will often be engaged in a common enterprise with the driver, and have the same interest in concealing the fruits or evidence of their wrongdoing." *Pringle*, 540 U.S. at 373 (quoting *Houghton*, 526 U.S. at 304-05). If the nexus of a car and its occupants is close enough to support the arrest of a passenger or search of a passenger's effects, it is surely close enough for a reasonable passenger to believe that he is not a mere bystander who is free to leave once the car is stopped.

Additionally, a reasonable passenger who knows that the officer can order him out of the car even if he does not wish to exit, *Maryland v. Wilson*, 519 U.S. 408, 410 (1997), may not only feel subject to the officer's authority, but fear the possible consequences of suddenly exiting the car without permission in the event that his attempt to leave is misconstrued by the police officer as a threat to the officer's or the public's safety.

Finally, the claim that passengers have not been seized also defies reality and common sense in another typical traffic stop scenario, when the officer approaches the car and asks for consent to search the vehicle. At that point, a reasonable passenger is likely to know that any rapid exit from the car — particularly if it is stopped in a high crime area — may itself constitute a basis for reasonable suspicion and hence further police action. *See Illinois v. Wardlow*, 528 U.S. 119, 124 (2000). Passengers in California, like

Brendlin, have even more reason to believe this is the case. The California Court of Appeal has explicitly stated that its precedent does not "stand for the proposition that after a traffic stop, the officer must stand by while the doors of the vehicle fly open and passengers leave in all directions." *People v. Castellon*, 76 Cal. App. 4th 1369, 1376 n.2 (Cal. Ct. App. 1999).

For all these reasons, it is entirely reasonable for passengers like Brendlin to conclude that they are not initially free to leave a car that has been pulled over by law enforcement. In fact, the situation of a car passenger like Brendlin is far different from that of petitioners in *Florida v. Bostick*, 501 U.S. 429 (1991), or *I.N.S. v. Delgado*, 466 U.S. 210 (1984), whose "freedom of movement was restricted by a factor independent of police conduct." *Bostick*, 501 U.S. at 436. In *Bostick*, petitioner was on a bus about to depart on a long distance trip and so would not have felt free to leave even if the police had not boarded the bus. *Id.* at 436. Similarly, in *Delgado*, petitioners were at work during normal working hours and were thus confined by virtue of that fact. 466 U.S. at 218. In contrast, a passenger in a car that has just been pulled over cannot be said to be free to go about his business, for his business was to continue in his travels in that car; instead, he has been brought to a halt solely by police conduct.[4]

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[4] This analysis does not mean that the initial seizure of a passenger created by virtue of a traffic stop is *per se* unreasonable; when there is reasonable suspicion to effect the traffic stop, *i.e.* the stop is lawful, the initial seizure of the passenger will be just as lawful as that of the driver. How long the seizure of a passenger may continue must depend on the totality of the circumstances in each case.

This analysis comports with the common sense assumptions reasonable people have regarding their rights during a traffic stop by recognizing that passengers like Brendlin are just as seized for Fourth Amendment purposes as the driver of the stopped car. It thus also means that passengers like Brendlin who have been subjected to an unlawful stop can vindicate their Fourth Amendment right to be free from unreasonable seizure in a court of law. Should this Court disagree, and find that all passengers are indeed initially free to leave a car as soon as it has been pulled over for a traffic stop, it should announce that holding unambiguously. Absent that clear holding, reasonable passengers will continue to believe that they are not free to leave until the police indicate otherwise.

B. The Lower Court Improperly Relied On The Subjective Intent Of The Officer To Conclude That A Reasonable Passenger Would Have Felt Free To Leave.

It is well settled that "a person has been 'seized' within the meaning of the Fourth Amendment if, in view of all of the circumstances surrounding the incident, a reasonable person would have believed that he was not free to leave." *Mendenhall*, 446 U.S. at 554; *Michigan v. Chesternut*, 486 U.S. 567, 574 (1988) ("This 'reasonable person' standard also ensures that the scope of Fourth Amendment protection does not vary with the state of mind of the particular individual being approached."). It is also clear that the seizure determination is to be made from the point of view of the person who is the object of the officer's attentions, rather than from that of the officer. *Mendenhall*, 446 U.S. at 555 n.6 ("[T]he subjective intention of the DEA agent in this case to detain the respondent, had she attempted

to leave, is irrelevant except insofar as that may have been conveyed to the respondent."); *cf. Whren v. United States*, 517 U.S. 806, 813 (1996) ("Subjective intentions play no role in ordinary, probable-cause Fourth Amendment analysis.").

Although the lower court opinion begins with an accurate recitation of the standard for determining whether a seizure has taken place, the one the court actually applied functionally eviscerates this Court's holding in *Mendenhall* by placing excessive emphasis on police officer intent. The California Supreme Court's inquiry referred throughout to the subjective intent of the police officer despite the fact that that intent was neither communicated to Brendlin nor would have been apparent to a reasonable person in his position. The court asserted, for example, that "Deputy Brokenbrough's flashing lights were directed at the driver, Karen Simeroth, and not at defendant." *Brendlin*, 38 Cal. 4th at 1118. A reasonable passenger, however, has no conceivable means of knowing at whom an officer's flashing lights are directed, particularly where, as here, there were no lawful grounds for the stop. Indeed, the lower court went so far as to state, "[w]e think it more sensible to leave it up to the officer, once cause for the vehicle stop has been established, to decide who should be seized and when." *Id.* at 1121 n.4.

The lower court's logic would place the determination of when a seizure has occurred squarely within the hands of officers themselves, who would be free to testify to their subjective intentions about whether and when a particular person was seized, regardless of whether those intentions were apparent. The protection afforded by the Fourth Amendment against unreasonable seizures becomes meaningless if police officers themselves are permitted to

provide *post hoc* determinations of whether and when a particular person had been seized — and thereby functionally to decide who is to be afforded Fourth Amendment protection.

The incentive for law enforcement officers simply to assert in all cases that the passengers at issue were not seized until after evidence was uncovered against them will be great, and perfectly lawful, if the lower court's rule is upheld. The problem raised by this possibility is precisely the reason why this Court has heretofore insisted upon an objective reasonableness standard from the point of view of the person confronted.

II. FAILING TO RECOGNIZE THAT PASSENGERS ARE SEIZED WILL PERMIT THE USE OF ARBITRARY AND DISCRIMINATORY STOPS THAT OFFEND THE CORE PRINCIPLES OF THE FOURTH AMENDMENT.

A. The Lower Court's Ruling Would Permit Arbitrary And Discriminatory Stops As To Passengers.

Although the issue before this Court is whether Brendlin was seized and not whether that seizure was in fact reasonable, the *per se* unreasonableness of the stop to which he was subjected is nevertheless relevant to this Court's inquiry.

The Fourth Amendment clearly prohibits both arbitrary and discriminatory seizures. *See, e.g., United States v. Martinez-Fuerte*, 428 U.S. 543, 554 (1976) ("The Fourth Amendment imposes limits on search-and-seizure powers in order to prevent arbitrary and oppressive interference by enforcement officials with the privacy and personal security of individuals."); *United States v. Brignoni-Ponce*, 422 U.S.

873, 878 (1975). Although the reasonableness of a seizure depends upon "a balance between the public interest and the individual's right to personal security free from arbitrary interference by law officers," *id.*, there is simply no legitimate public interest in arbitrary or discriminatory stops, and they are accordingly unlawful. Such stops are not, and should not, be shielded from Fourth Amendment scrutiny.

It is axiomatic that the driver of a vehicle that was arbitrarily or discriminatorily stopped may vindicate her Fourth Amendment rights, for example, via a motion to suppress evidence that would not have been gathered but for the stop. Should this Court affirm the California court's ruling, however, any evidence gathered against passengers in the very same car will be admissible even though it too was the product of an unlawful stop. The lower court's ruling would create the incongruous situation in which the same evidence gathered from the same concededly unlawful stop, which affected both driver and passenger equally, could be used against one person in the car but not another. It would functionally permit baseless stops with respect to a whole class of people: passengers.

The California Supreme Court's ruling creates an incentive for law enforcement to take advantage of that incongruity. Because evidence uncovered as a result of an arbitrary or discriminatory stop would still be admissible against passengers, law enforcement officers will have little reason to curtail such stops. This is not an incentive structure that the Fourth Amendment was designed to tolerate; an increase in arrests and convictions may result, but at a price this Court has already repeatedly rejected. *See, e.g., Almeida-Sanchez v. United States,* 413 U.S. 266, 273 (1973) (finding a roving Border Patrol stop and search without

probable cause or reasonable suspicion unconstitutional under the Fourth Amendment); *Carroll v. United States*, 267 U.S. 132, 153-54 (1925) ("It would be intolerable and unreasonable if a prohibition agent were authorized to stop every automobile on the chance of finding liquor, and thus subject all persons lawfully using the highways to the inconvenience and indignity of such a search.").

In *Whren*, this Court suggested that allegations of racial profiling can be addressed through an Equal Protection claim seeking damages and injunctive relief. 517 U.S. at 813. This Court did not suggest, however, that a Fourth Amendment violation and an Equal Protection violation represent the same constitutional injury, or that redress for one provides satisfactory redress for the other. Rather, the Court held in *Whren* that there had been no Fourth Amendment violation to redress because the car stop at issue there was lawful. *Id.* Here, by contrast, the car stop was concededly unlawful.

Unlike the knock-and-announce violation in *Hudson v. Michigan*, 126 S. Ct. 2159 (2006), moreover, the unlawful car stop in this case involved more than an issue of timing. The entry into Hudson's home would only have been delayed for a few seconds had the officers properly knocked and announced their presence. Brendlin, on the other hand, would never have been seized as part of the car stop if the police in this case had complied with the Fourth Amendment. The increased threat to privacy creates a correspondingly increased need for an effective deterrent against police misconduct.

Furthermore, the fact that someone else in the vehicle may bring a constitutional claim to remedy systemic deficiencies (*i.e.*, the driver), does not mean that others who

have suffered from the same Fourth Amendment violation should be unable to do so — particularly where, as here, the two parties may have wholly different legal interests.

Finally, the necessity of showing a pattern and practice of racial discrimination can be nearly insurmountable for individuals, much less a showing of actual discriminatory intent. *See, e.g.*, *Chavez v. Ill. State Police*, 251 F.3d 612 (7th Cir. 2001). There will also be individuals who do not wish to file a civil action or do not have a civil claim, but rather only seek to exclude evidence that was gathered against them perhaps as the result of a racially suspect stop and search.

B. The Lower Court Ruling And The Incentives It Would Create For Law Enforcement Would Disproportionately Affect Minorities.

The incentive the California court ruling creates for police officers to engage in arbitrary stops would, of course, affect all passengers. But the discriminatory stops and attendant searches it would newly permit with respect to passengers will have particular resonance for minority motorists. Statistical evidence tells us that minority passengers will be disproportionately affected by a ruling that bars passengers in general from challenging unlawful stops and by any increase in the number of unlawful stops that result from such a ruling. Some data indicates that minority motorists are stopped at higher rates than their white counterparts. Much more data establishes that minority motorists are disproportionately subjected to searches once they have been stopped — even though searches of minorities are not any more likely to uncover evidence of criminal wrongdoing than searches of whites. A disproportionate number of minority passengers will

accordingly be left without Fourth Amendment recourse when subjected to discriminatory stops if this Court affirms the lower court's ruling.

i. Stop Rates

There is some evidence that cars with African American occupants are more likely to be stopped, even when there is no law enforcement incentive to engage in arbitrary or discriminatory stops.[5] For example:

- *Kansas*: In a multijurisdictional report on traffic stops, the Police Foundation found that, of the seven Kansas police departments assessed, "all are targeting either Blacks or Hispanics and three of the six who were assessed for both Blacks and Hispanics are targeting both."[6]
- *Maryland*: In an official report to the State, the Maryland Justice Analysis Center found that 36% of all stops in Maryland were of African Americans. The report concluded that "the fact that 36% of all the law eligible stops involved a black driver does raise concerns given that the population in Maryland is 28% black."[7]
- *Minnesota*: A statewide survey found that all minority populations, except Asians, were stopped at a higher rate

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[5] *See generally*, David Rudovsky, *The Impact of the War on Drugs on Procedural Fairness and Racial Equality*, 1994 U. CHI. LEGAL. F. 237, 250 (1994) (discussing evidence of racial disparity in traffic stops).

[6] JOHN C. LAMBERTH, POLICE FOUND., A MULTIJURISDICTIONAL ASSESSMENT OF TRAFFIC ENFORCEMENT AND DATA COLLECTION IN KANSAS 143 (2003), *available at* http://www.racialprofilinganalysis.neu.edu/IRJ_docs/KS_2003.pdf.

[7] MD. JUSTICE ANALYSIS CTR., REPORT TO THE STATE OF MARYLAND ON LAW ELIGIBLE TRAFFIC STOPS 8 (2004), *available at* http://www.mdle.net/traffic/2004report.pdf [hereinafter MARYLAND REPORT].

than whites. African American motorists were stopped at the highest rate — over three and a half times more often than white motorists.[8]

- *Minnesota (St. Paul)*: A 2001 study by the Institute on Race & Poverty concluded that African Americans in St. Paul, Minnesota, were stopped in disproportionately high numbers compared to their proportion of the city's adult population. Whites, who represented 73.18% of the population, accounted for only 57.67% of all stops whereas African Americans, who represented 10.22% of the population, accounted for 26.25% of all stops.[9]

- *Missouri*: The state Attorney General reported that African Americans in Missouri represent 10.6% of the adult population but 15.1% of all vehicle stops. In other words, African Americans are stopped at a rate 42% higher than expected based solely on their proportion of the adult population. African Americans were 46% more likely than whites to be stopped in 2005.[10]

There is also evidence that, despite this Court's admonitions more than 30 years ago in *Brignoni-Ponce* and *Almeida-Sanchez*, traffic stops are also being conducted on

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[8] INST. RACE & POVERTY, MINNESOTA STATEWIDE RACIAL PROFILING REPORT: ALL PARTICIPATING JURISDICTIONS 10 (2003), *available at* http://www.irpumn.org/uls/resources/projects/aggregate%20report%2092303.pdf [hereinafter MINNESOTA REPORT].

[9] INST. RACE & POVERTY, REPORT ON TRAFFIC STOP DATA COLLECTED BY THE SAINT PAUL POLICE DEPARTMENT APRIL 15 THROUGH DECEMBER 15, 2000 4-6 (2001), *available at* http://www1.umn.edu/irp/SPPD0522.pdf [hereinafter ST. PAUL REPORT]

[10] ATTORNEY GEN. OF THE STATE OF MO., MISSOURI VEHICLE STOPS 2005 ANNUAL REPORT, *available at* http://www.ago.mo.gov/racialprofiling/2005/racialprofiling2005.htm#findings [hereinafter MISSOURI REPORT].

people suspected of being Mexican in order to check their immigration status.[11]

Although other jurisdictions have not reported any racial discrepancies in their stop rates, there is good reason to believe that such discrepancies are underreported because of the use of unadjusted census data. Many stop rate studies use the proportion of minorities in the general population as a baseline in order to assess racial discrepancies. As the Police Executive Research Forum notes, however, stop rates calculated using such data do not take into account the fact that the proportion of minorities who own and use vehicles may be smaller than the proportion of that minority group in the population at large.[12] Seemingly benign stop rates may thus actually mask racially biased policing. In addition, increased police discretion to engage in unlawful stops with impunity with respect to passengers may well result in further racial discrepancies in stop rates.

ii. Search Rates

Even if the rate at which minorities and whites are stopped were identical, the evidence that race matters once a car has been stopped is striking. In a national survey published in 2006, the United States Department of Justice found that African Americans were nearly three times as

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[11] *See, e.g., Farm Labor Org. Comm. v. Ohio State Highway Patrol*, 95 F. Supp. 2d 723, 737 (N.D. Ohio 2000); Jim Yardley, *Some Texans Say Border Patrol Singles Out Too Many Blameless Hispanics*, N.Y. TIMES, Jan. 26, 2000, at A17; Susan Sachs, *Files Suggest Profiling of Latinos Led to Immigration Raids*, N.Y. TIMES, May 1, 2001, at B1.

[12] LORIE A. FRIDELL, POLICE EXECUTIVE RESEARCH FORUM, BY THE NUMBERS: A GUIDE FOR ANALYZING RACE DATA FROM VEHICLE STOPS 75 (2004), *available at* http://www.justice.utah.gov/Research/Race/PERF%20by%20the%20Numbers.pdf.

likely and Hispanics more than twice as likely as whites to be physically searched or to have their vehicles searched when their cars were stopped.[13] For men over 25, the discrepancy was even more pronounced, with African Americans close to three and a half times more likely and Hispanics over three times more likely to be searched than whites.[14]

The statistics available for jurisdictions across the country are consistent, and unrelenting:

- *California (Sacramento)*: In a 2003 report, the University of Southern California concluded that "it is apparent that both African American and Hispanic drivers [in Sacramento] are subject to more intrusive stops than white drivers. . . . African American and Hispanic drivers are asked to exit their cars, searched, and detained for 30 minutes or longer about twice as often as white drivers." The search rates reported in the study establish discrepancies among African Americans (25.3% stopped are searched), Hispanics (22.6%), and whites (11.7%).[15]

- *California (San Diego)*: An official review of 2001 traffic stops in San Diego revealed that African Americans were disproportionately subjected to consent searches, the most

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[13] African Americans were searched 10.2% of the time, compared to 11.4% for Hispanics and 3.5% for whites. BUREAU OF JUSTICE STATISTICS, U.S. DEP'T OF JUSTICE, CHARACTERISTICS OF DRIVERS STOPPED BY POLICE 2002 5 (2006), *available at* http://www.ojp.usdoj.gov/bjs/pub/pdf/cdsp02.pdf [hereinafter BUREAU OF JUSTICE STATISTICS].

[14] African American men over 25 were searched 13.8% of the time and Hispanics 12.9% of the time, compared to 4% of white men over 25. *Id.*

[15] HOWARD P. GREENWALK, UNIV. OF S. CAL., POLICE VEHICLE STOPS IN SACRAMENTO, CALIFORNIA 32-33 (2003), *available at* http://www.cityofsacramento.org/spdata/pdf/data_collection_report_2002.pdf [hereinafter SACRAMENTO REPORT].

discretionary form of search. African American drivers represented 16.1% of consent searches, "well above their 10.4% portion of vehicle stops." Hispanic representation in consent search rates was also disproportionate — 32.5% of consent searches compared to 27.7% of stops.[16]

- *Colorado*: Of individuals stopped by the State Patrol in 2002, Hispanic drivers comprised 15% of those stopped, but over 30% of those searched.[17]

- *Illinois*: In 2006, a state-sponsored study of the prior year's traffic stops revealed that minority motorists were more likely to be subjected to a consent search than white motorists. The survey concluded that "in spite of the fact that there are fewer consent searches [than in 2004], application of consent searches by race has become more problematic."[18]

- *Maryland*: A 2004 statewide survey of traffic stops in Maryland established that the highest rate of searches was for Hispanic males (9.9% stopped are searched) followed by African American males (7.5%), and white males (5.6%).[19]

- *Minnesota (St. Paul)*: According to data gathered by the St. Paul Police Department, after being stopped, African

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[16] DR. GARY CORDNER ET AL., VEHICLE STOPS IN SAN DIEGO: 2001 8 (2002), *available at* http://www.sandiego.gov/police/pdf/stoprpt.pdf.

[17] COLORADO STATE PATROL, 2002 TRAFFIC STOP SUMMARY 8 (2004), *available at* http://csp.state.co.us/Upload/03trafficstopdata.pdf [hereinafter COLORADO REPORT].

[18] ALEXANDER WEISS & AVIVA GRUMET-MORRIS, NORTHWESTERN UNIV. CTR. PUB. SAFETY, ILLINOIS TRAFFIC STOPS STATISTICS STUDY, 2005 ANNUAL REPORT 7 (2006), *available at* http://www.dot.state.il.us/trafficstop/2005annualreport.pdf.

[19] MARYLAND REPORT, *supra* note 7, at 9.

Americans, Hispanics and Native Americans in St. Paul, Minnesota, are subjected to pat down searches of their persons and searches of their vehicles at rates higher than the search rates for white drivers. For example, in searches that produced no contraband whatsoever, 19.6% of African Americans and 16.7% of Hispanics, but only 8.4% of whites, were patted down and had their vehicles searched.[20]

- *Missouri*: The 2005 Annual Report of the Attorney General's Office found that, across the state of Missouri, African Americans were 1.78 times more likely to be searched than whites and Hispanics 1.98 times more likely.[21]

- *Ohio (Cleveland)*: A 2006 University of Cincinnati report found that, even after controlling for other relevant factors, a driver's race has a "significant influence over whether or not searches are conducted [in Cleveland]. The odds of being searched are 1.3 times higher for Black drivers compared to Caucasian drivers." The report also found that African American motorists were more likely to be searched for discretionary reasons.[22]

- *Rhode Island*: An official review of statewide traffic stops in Rhode Island found that 2.9% of whites but 5.9% of non-whites were subject to a discretionary search upon being stopped by the police. In other words, "non-whites are significantly more likely than whites to be subjected

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[20] SAINT PAUL REPORT, *supra* note 9, at 4, 15.

[21] MISSOURI REPORT, *supra* note 10.

[22] ROBIN ENGEL ET AL., UNIV. OF CINCINNATI DIV. OF CRIMINAL JUSTICE, CLEVELAND DIVISION OF POLICE TRAFFIC STOP DATA STUDY: FINAL REPORT xiii (2006), *available at* http://www.uc.edu/criminaljustice/ProjectReports/Cleveland_Traffic_Stop_Study.pdf.

to a discretionary search. Statewide, the odds of a non-white motorists [sic] being searched are roughly twice that of a white driver being searched."[23]

- *Tennessee*: A statewide survey of traffic stops in Tennessee found that police officers searched 16.8% of Hispanics stopped, 8.1% of African Americans, and 5.8% of whites. When stopping vehicles for moving violations, officers searched 14.1% of Hispanics, 5.7% of African Americans, and 4.4% of whites. When stopping vehicles for vehicle equipment violations, officers searched 20.3% of Hispanics, 12.7% of African Americans, and 8.3% of whites.[24]

A rule that bars passengers from challenging the unlawfulness of a stop (and the admissibility of the fruits of that stop) would disproportionately affect minorities because minority motorists are disproportionately searched. While the rule announced by the California high court has troubling implications for all passengers — particularly given the incentive it provides to law enforcement to increase the number of unreasonable stops in the hopes of gathering otherwise inadmissible evidence — minorities will be particularly affected given the reality of disproportionate search rates.

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[23] AMY FARRELL & JACK MCDEVITT, INST. RACE & JUSTICE, RHODE ISLAND TRAFFIC STOP STATISTICS 2004-2005 FINAL REPORT 2 (2006), *available at* http://www.rijustice.ri.gov/sac/Executive%20Summary%202004-2005.pdf [hereinafter RHODE ISLAND REPORT].

[24] COMPTROLLER OF THE TN TREASURY, VEHICLE STOPS AND RACE: A STUDY AND RESPONSE TO PUBLIC CHAPTER 910 OF 2000 15-16 (2002), *available at* http://www.comptroller.state.tn.us/orea/reports/racialprofiling.pdf [hereinafter TENNESSEE REPORT].

iii. Hit Rates

Such an outcome might be justified by law enforcement if the widespread disparity in search rates between different racial groups reflected the rates at which those populations violate the law. Studies over the last several years, however, have consistently found *no difference in contraband discovery rate across race* — clear cut proof that racial profiling not only offends core constitutional principles, but is also an ineffective law enforcement strategy. The DOJ, for example, recently concluded that despite the differences in search rates across race, "no measurable differences were found in the likelihood of arrest among white, black, and Hispanic male drivers."[25] Again, this pattern is consistently repeated throughout the United States:

- *California (Sacramento)*: Despite finding variation among search rates across race, a University of Southern California study of traffic stops in Sacramento, California, established that contraband is found at similar rates across race, with African Americans (22.4%) having the lowest rate compared to Hispanics (27.9%) and whites (26.4%).[26]

- *Colorado*: In 2002, whites were more likely to have a seizure of contraband or property during traffic stops when compared to the number of searches that took place. Meanwhile, Hispanics were the *least* likely group to have contraband or property seized during a traffic stop, despite being the group *most* likely to be searched.[27]

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25 BUREAU OF JUSTICE STATISTICS, *supra* note 13, at 6.

26 SACRAMENTO REPORT, *supra* note 15, at 8, 34.

27 COLORADO REPORT, *supra* note 17, at 14.

- *Maryland*: Despite disproportionate search rates involving motorists of color in this state, nothing is seized in 84% of searches of African Americans, 89% of searches of Hispanics, and 83% of whites. There also does not appear to be any meaningful difference in the number of arrests subsequent to stops for blacks and whites.[28]

- *Minnesota*: While 12.61% of African American motorists who were stopped were searched compared to 3.14% of white motorists, contraband was discovered at a rate of 11.17% for African Americans and 23.53% for whites. Similarly, Latinos accounted for 8.55% of searches, but only 9.08% of contraband hits — far below the contraband hit rate for white motorists.[29]

- *Minnesota (St. Paul)*: African Americans, Hispanics and Native Americans were far more likely than whites to be subject to pat down searches and vehicle searches in which no contraband was found. No contraband was found in 19.6% of searches involving African Americans, 16.7% of Hispanics, 16.6% of Native Americans, and 8.4% of whites.[30]

- *Missouri*: In 2005, the contraband hit rate for whites was 23.6%, compared with 18.6% of African Americans and 14.5% for Hispanics. The Attorney General's Office concluded that "this means that on average, searches of African Americans and Hispanics are less likely than searches of whites to produce contraband."[31]

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28 MARYLAND REPORT, *supra* note 7, at 10-11.

29 MINNESOTA REPORT, *supra* note 8, at 22.

30 SAINT PAUL REPORT, *supra* note 9, at 15.

31 MISSOURI REPORT, *supra* note 10.

- *Rhode Island*: White contraband rates in this state are 26.5%, and non-white rates are 22.3%.[32]

- *Tennessee*: As a result of searches in Tennessee, officers seized evidence from 1.8% of Hispanics, 1.6% of African Americans, and 1.2% of whites.[33]

This data establishes that there is no law enforcement rationale to which this Court should defer in considering the racial profiling implications of this case. This Court should not affirm a rule that would leave minorities, who are subjected to disproportionate search rates but do not disproportionately offend, without any Fourth Amendment protections to challenge flatly discriminatory stops and searches.

The Fourth Amendment currently provides an avenue of redress for those subjected to discriminatory stops and searches, whether via a suppression motion or a civil claim challenging racial profiling practices.[34] And, as this Court

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[32] RHODE ISLAND REPORT, *supra* note 23, at 3.

[33] TENNESSEE REPORT, *supra* note 24, at 18.

[34] A number of suits contesting racial profiling practices have resulted in consent decrees or judicial orders that require police departments to collect relevant data, implement officer training programs, and prohibit officers from pulling motorists over on the basis of race or skin color. *See, e.g., Wilkins v. Md. State Police*, No. 93-468 (D. Md. 2003), *available at* http://www.mdsp.org/downloads/consent_decree.pdf; *Arnold v. Ariz. Dep't of Pub. Safety*, No. 01-01463 (D. Ariz. 2006), *available at* http://www.azdps.gov/SettlementAgreement.pdf; *Rodriguez v. Cal. Highway Patrol et al.*, 89 F. Supp. 2d 1131 (N.D. Cal 2000); *Martinez v. Mount Prospect*, 92 F. Supp. 2d 780 (N.D. Ill. 2000); *United States v. New Jersey*, No.99-5970 (D.N.J 1999), *available at* http://www.usdoj.gov/crt/split/documents/jerseysa.htm. Moreover, courts have consistently approved of the use of the Fourth Amendment to redress allegations of racial profiling. *See, e.g., Md. State Conference of*

has recognized, these court actions can have particular bite when they are coupled with a § 1983 claim. *See, e.g.*, *Hudson v. Michigan*, 126 S. Ct. at 2167-68 ("As far as we know, civil liability is an effective deterrent here, as we have assumed it is in other contexts."). A ruling that forecloses a legal remedy under the Fourth Amendment for passengers would gut the primary deterrent to such behavior.

It would be unfortunate if after the great strides the lower courts in this country have made to combat racial profiling via the judicial system — and the great strides the states have made to combat racial profiling via increased data collection and reporting — this Court were inadvertently to re-open a door that should properly be closed.

NAACP Branches, et al. v. Md. Dep't of State Police, 72 F. Supp. 2d 560 (D. Md. 1999).

CONCLUSION

For the reasons stated above, the judgment of the California Supreme Court should be reversed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

TELLABS, INC., ET AL.,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,
Respondents.

On Writ of Certiorari to the United States Court Appeals for the Seventh Circuit

BRIEF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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BRIEF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

INTEREST OF THE *AMICUS CURIAE* [1]

The North American Securities Administrators Association, Inc. ("NASAA"), is the nonprofit association of state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. It has 67 members, including

[1] Pursuant to SUP. CT. R. 37.6, NASAA represents that no counsel for any party authored this brief in whole or in part, and no person or entity, other than NASAA, its members, or its counsel, made any monetary contribution to the preparation or submission of the brief. Pursuant to SUP. CT. R. 37.3, NASAA further represents that all parties to this appeal have consented to the filing of this brief. Copies of their written consents have been filed with the Court.

the securities regulators in all 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Formed in 1919, it is the oldest international organization devoted to protecting investors from fraud and abuse in the offer and sale of securities.

The U.S. members of NASAA are responsible for administering state securities laws and regulations. Their activities include regulatory functions such as licensing broker-dealers, registering local securities offerings, and conducting compliance examinations. Especially important is their enforcement role: protecting the nation's investors by bringing literally thousands of enforcement actions every year against the firms and individuals who have committed fraud and abuse in the sale of securities. In those cases, state securities regulators often seek restitution to help make injured investors whole, although both state and federal regulators recognize that the best hope of recovery for the vast majority of defrauded investors is through the courts in private actions for damages.

NASAA supports the work of its members through training programs, enforcement assistance, and legislative analysis. Another important role of the association is representing the membership's position as *amicus curiae* in significant cases brought by private plaintiffs as well as government regulators involving the interpretation of the securities laws and the rights of investors. *See, e.g.,* Brief of the North American Securities Administrators Association, Inc., as *Amicus Curiae,* in Support of Respondents Broudo *et al.*, in *Dura Pharmaceuticals, Inc. v. Broudo*, Case No. 03-932 (U.S. Nov. 17, 2004) (supporting investors' position on the pleading requirements for loss causation in a private action for securities fraud), *available at* http://www.nasaa.org/content/Files/BroudoBrief.pdf; Brief of *Amicus Curiae* North American Securities Administrators Association, Inc., in Support of the People of the State of California, in *People v. Edward D. Jones & Co.,* Case No. CO53407 (Cal. Ct. App. Feb. 23,

2007), *available at* http://www.nasaa.org/content/Files/ED_JONES_FINAL.pdf.

NASAA and its members have a stake in the outcome of this appeal because it will have a profound impact upon the ability of investors to seek redress in cases where unscrupulous issuers and corporate executives have perpetrated a fraud on the market. The Seventh Circuit correctly ruled that a complaint for securities fraud satisfies the pleading requirements for scienter under the Private Securities Litigation Reform Act of 1995 ("Reform Act" or "Act") if the allegations in the complaint collectively establish a strong inference of scienter. *See Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 601 (7th Cir. 2006), *cert. granted*, 127 S.Ct. 853 (2007). The court rightly rejected the far more onerous requirement that courts actually evaluate competing inferences upon a motion to dismiss and afford the plaintiff only those inferences that are most plausible. *Id.* at 602. If this Court were to reverse the lower court and establish the more burdensome standard as the federal rule governing scienter at the pleading stage, many victims of securities fraud with meritorious claims would lose the opportunity to recover their damages. As advocates for the rights of investors to seek redress, NASAA and its members have an interest in supporting affirmance and minimizing this threat.

This Court's decision will also affect the role of private actions as a deterrent against securities fraud. Private actions by defrauded investors are an enormously important complement to regulatory enforcement actions as a means of policing the securities marketplace. State and federal securities regulators work tirelessly to detect, enjoin, and punish financial fraud. However, private actions not only provide the principal means of redress for victims of securities fraud, they also play a vitally important role in protecting the integrity of the marketplace through deterrence. Congress and the courts alike have recognized this fact. The Senate Report accom-

panying the Reform Act described the importance of private rights of action as follows:

> The SEC enforcement program and the availability of private rights of action together provide a means for defrauded investors to recover damages and a powerful deterrent against violations of the securities laws. As noted by SEC Chairman Levitt, "private rights of action are not only fundamental to the success of our securities markets, they are an essential complement to the SEC's own enforcement program." (citation omitted)

See S. REP. NO. 104-98, at 8 (1995) ("Senate Report"), *reprinted in* 1995 U.S.C.C.A.N. 679, 687; *see also Basic Inc. v. Levinson*, 485 U.S. 224, 230-31 (1988) (observing that the private cause of action for violations of Section 10(b) and Rule 10b-5 constitutes an "essential tool for enforcement of the 1934 Act's requirements"). To the extent that the Court erects unwarranted barriers to recovery in private actions, such as the pleading requirements for scienter advanced by the Petitioners, the Court will undermine an important deterrent that benefits the marketplace as a whole. For this additional reason, NASAA and its members support affirmance of the circuit court's decision.

SUMMARY OF THE ARGUMENT

The Seventh Circuit correctly held that a complaint for securities fraud satisfies the pleading requirements for scienter under the Reform Act if the allegations in the complaint collectively establish a strong inference of scienter. This formulation is precisely what the Reform Act says and what Congress intended the courts to apply. Moreover, the Seventh Circuit's rule advances the Congressional policy of discouraging meritless lawsuits, while minimizing restrictions on access to the courts by the ever-increasing number of investors who are genuine victims of securities fraud. The rule advanced by Petitioners and their *amici*, suggesting that courts must instead evaluate competing inferences upon a

motion to dismiss and afford the plaintiff only those inferences that are most plausible, should be rejected. It has no support in the language or legislative history of the Reform Act. Moreover, by calling upon courts to weigh competing evidentiary claims, it violates the universally accepted interpretation of Rule 12(b)(6), as well as the Seventh Amendment guarantee of trial by jury. And the Petitioners' rule would severely limit access to the courts for injured investors, at a time when the need to address rampant financial fraud far outweighs the need to protect companies and their executives from strike suits.

ARGUMENT

I. THE SEVENTH CIRCUIT CORRECTLY FORMULATED AND APPLIED THE PLEADING STANDARD FOR SCIENTER UNDER THE REFORM ACT

The Seventh Circuit held that when evaluating the adequacy of scienter allegations on a motion to dismiss under the Reform Act, courts should examine all of the allegations in the complaint and decide whether collectively they establish a strong inference of scienter. *Makor*, 437 F.3d at 601. This simple test faithfully adheres to the actual language of the Reform Act, it comports with the Act's legislative history, and it strikes the right balance between the two policies underlying the Act: eliminating meritless strike suits while preserving the right of investors to seek damages for securities fraud. The circuit court's interpretation of the Reform Act was therefore correct and should be affirmed.

A. The Seventh Circuit's Test Follows The Plain Language Of The Reform Act

"[T]he starting point in any case involving the meaning of a statute is the language of the statute itself." *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 210 (1979); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 533 (3rd Cir.

1999) (focusing attention on the Reform Act's plain language, "which is the customary starting point in statutory interpretation"). With respect to allegations of scienter, the Reform Act simply provides that a complaint alleging securities fraud must "state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added). This is precisely the test that the Seventh Circuit adopted in its opinion. *See, e.g., Makor,* 437 F.3d at 603 ("We can now assess whether the complaint states, with respect to each of these actionable statements, facts that give rise to a *strong inference* of scienter.") (emphasis added); *id.* at 605 ("[W]e find that the complaint contains enough detail to establish a *strong inference* that Notebaert knew of the channel stuffing and therefore knew Tellabs had exaggerated its fourth quarter 2000 revenues.") (emphasis added); *id.* at 604 ("We conclude that the plaintiffs have pleaded sufficient facts to 'giv[e] rise to a *strong inference*,' 15 U.S.C. § 78u-4(b)(2), that Notebaert knowingly lied . . . .") (emphasis added).[2] The Seventh Circuit clearly based its analysis on an accurate reading of the Reform Act.

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[2] These excerpts from the Seventh Circuit's opinion refute any suggestion that the court's test for pleading scienter *after* adoption of the Reform Act is no more stringent than the test applicable *before* adoption of the Reform Act. *See also Makor,* 437 F.3d at 601 (the Reform Act "did unequivocally raise the bar for pleading scienter"); *id.* at 600 (adequately pleading scienter under the Reform Act requires plaintiffs to clear "another, even more arduous hurdle"). Nor does the Seventh Circuit's reference to a "reasonable person" standard support the Petitioners' contention on this issue. The court used that phrase not to dilute the "strong inference" requirement, but as an alternative to the Sixth Circuit's unacceptable suggestion that courts must weigh competing inferences and afford plaintiffs only those that are most reasonable. *Id.* at 602. Rather than balancing inferences, the court's role under the Seventh Circuit's analysis is simply to determine if a "reasonable person" could arrive at the requisite *strong* inference.

B. The Seventh Circuit's Test Comports With The Legislative History

The Seventh Circuit also considered the legislative history of the Reform Act. Although generally regarded as "contradictory and inconclusive," *see Makor*, 437 F.3d at 601 (quoting *In re Advanta Corp.*, 180 F.3d at 533), the legislative history is clear at least on this point: Congress deliberately chose to fashion a strong but simple test, unencumbered with embellishments derived from the case law. The Conference Report confirms that the standard was intended to be precisely what the statute says: the plaintiff's facts, stated with particularity, "must give rise to a 'strong inference' of the defendant's fraudulent intent." H.R. CONF. REP. NO. 104-369, at 41 (1995) ("Conference Report"), *reprinted in* 1995 U.S.C.C.A.N. 730, 740. While acknowledging that the standard was derived in part from the test in the Second Circuit, the Report expressly disavows any intention "to codify the Second Circuit's case law interpreting this pleading standard." *Id.* The report further explains that "for this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness." Conference Report at n.23. The legislative history thus supports the Seventh Circuit's observation, shared by the majority of the federal circuit courts, that "Congress chose neither to adopt nor reject particular methods of pleading scienter—such as alleging facts showing motive and opportunity—but instead only required plaintiffs to plead facts that together establish a strong inference of scienter." *See Makor*, 437 F. 3d at 601 (quoting *Ottman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003)).

C. The Seventh Circuit's Test Advances The Goal Of Limiting Groundless Class Action Lawsuits, While Minimizing The Adverse Impact On Meritorious Claims By Injured Investors

In the Reform Act, Congress sought to "strike the right balance between protecting the rights of victims of securities fraud and the rights of public companies to avoid costly and meritless litigation." *See* Senate Report at 10. Congress clearly wanted to inhibit abusive lawsuits, but at the same time it recognized that "[p]rivate securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action." *See* Conference Report at 31. Moreover, Congress recognized that "[s]uch private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs." *Id.* The Conference Report begins with the affirmation that "[t]he *overriding* purpose of our nation's securities laws is to protect investors and to maintain confidence in our capital markets . . . ." (emphasis added). *See* Conference Report at 31; *see also Makor*, 437 F.3d at 595 (establishing, as a backdrop to its analysis, that "the modern securities laws were designed . . . to 'substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry") (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)).

The Seventh Circuit's interpretation of the Reform Act's heightened pleading standard for allegations of scienter accommodates both of these Congressional policy goals. The circuit court's analysis obviously recognizes that allegations of scienter in a securities fraud action must be subjected to more "arduous" scrutiny under the Reform Act. *See Makor*, 437 F.3d at 600. The court's holding thus serves the purpose

of deterring unfounded lawsuits. At the same time, however, the court refused to graft onto the statute's plain language the vastly more repressive balancing-of-inferences test advocated by the Petitioners. The court's holding thus also advances Congress's goal of preserving meaningful recourse for bona fide victims of securities fraud.[3]

The need to ensure that investors have meaningful private remedies in federal court has become starkly apparent since the passage of the Reform Act. Over the last several years, there has been a marked rise in the incidence of corporate accounting fraud and securities law violations affecting large classes of investors. *See, e.g.*, Press Release, No. 2002-179, SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices (SEC, Dec. 20, 2002), *available at* http://www.sec.gov/news/press/2002-179.htm; *see also* Press Release, State Investigation Reveals Mutual Fund Fraud (Office of New York Attorney General, Sept. 3, 2003), *available at* http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html.

Congress recognized the seriousness of the problem, and the need for at least a partial legislative response, when it enacted the Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7201-7266. The House Report accompanying the House bill aptly describes the problem of deceptive corporate practices that harm investors:

> The collapse of the Enron Corporation provided irrefutable evidence of serious, systemic problems in our

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[3] On its face, at least, the Seventh Circuit's disposition of the Petitioners' specific challenges to the complaint suggests that the "strong inference" standard is a rigorous screening mechanism for fraud claims. Although the court sustained a number of fraud allegations against one of the two individual defendants, it dismissed all of the complaint's allegations against the other individual defendant, finding that "the plaintiffs did not meet the strict PSLRA standards for pleading Birck's scienter." *See Makor*, 437 F.3d at 603-04.

> financial reporting system and our capital markets. Far from being an isolated instance, Enron was only the most spectacular example of what has become a common phenomenon—earnings manipulation and deceptive accounting by our largest companies. Before Enron, company after company—Waste Management, Sunbeam, Cendant, W.R. Grace, and many others—were found to have manipulated their accounting to present a picture to investors that did not match reality. As evidenced by the record number of investigations opened by the SEC thus far this year [2002], the problem has only become more acute.

See H.R. REP. NO. 107-414 (2002), 2002 WL 661614, *47 (Minority Views).[4]

This corporate fraud has harmed millions of investors nationwide, inflicting huge personal losses. Yet the number of securities fraud class action lawsuits filed in the federal courts has declined, and dismissal rates have increased, since the Reform Act was passed. *See generally Hearing on H.R. 5491, Before the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises,* 109th Cong. (2006) (Statement of James D. Cox), *available at* http://www.law.duke.edu/features/pdf/ coxtestimony.pdf; Ronald I. Miller, Todd Foster, and Elaine Buckberg, *Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, is Stabilization Ahead?* Apr. 2006, *available at* http://www.nera.

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[4] For the most part, the laudable provisions of Sarbanes-Oxley are focused on enhancing the regulatory oversight of corporate accounting practices and toughening the penalties for violations of the securities laws. *See, e.g.,* Title I, 15 U.S.C. §§ 7211-19 (establishing an accounting oversight board for public companies); Title VIII, Section 807, 18 U.S.C. § 1348 (increasing criminal penalties for defrauding shareholders of publicly traded companies). It remains for the courts to interpret the securities laws in a manner that affords investors an adequate means of redress for corporate malfeasance.

com/image/BRO_RecentTrends2006_SEC979_PPB-FINAL.pdf (National Economic Research Associates, Inc.). These conflicting trends have prompted experts in the securities field to surmise that because of the Reform Act, "the balance has been tipped too far in favor of preventing claims (some of which would, after discovery, turn out to have merit) rather than protecting investors who have suffered losses. That is, Congress swung the pendulum too far in protecting defendants." Kevin S. Schmelzer, *The Door Slammed Shut Needs to be Reopened: Examining the Pleading Requirements Under the Private Securities Litigation Reform Act*, 78 Temp. L. Rev. 405, 426 (2005); *see also* Joel Seligman, *Rethinking Private Securities Litigation*, 73 U. Cin. L. Rev. 95, 113 (2004) ("the diminution in the effectiveness of private federal securities litigation was one of the several facts that contributed to a reduction in fraud deterrence."). The Seventh Circuit's ruling at least minimizes this regulatory imbalance that favors defendants at the expense of investors.

Another factor supporting the Seventh Circuit's interpretation of the Reform Act is the limited availability of alternative recourse for the victims of securities fraud in the state courts. This Court has observed that the disadvantages posed by a restrictive interpretation of federal securities law can be "attenuated" where adequate remedies are available under state law. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 738 n.9 (1975) (standing to bring private cause of action under Rule 10b-5 limited to actual purchasers or sellers). Conversely, where state courts do not offer an adequate alternative forum for plaintiffs' claims, federal courts have a correspondingly greater justification for providing relief.

In this case, state law offers limited recourse for investors in the Respondents' position. Congress has expressly limited the use of class action suits seeking recovery for securities fraud under state law. In 1998, Congress enacted the Securi-

ties Litigation Uniform Standards Act ("SLUSA") to address the concern that "securities class action lawsuits [had] shifted from Federal to state courts" as a means of circumventing the Reform Act. *See* Pub. L. No. 105-353, § 2(1), (2), 112 Stat. 3227. With certain exceptions, SLUSA provides that no class action based upon state law may be maintained in any state court on behalf of more than 50 class members. *See* 15 U.S.C. § 77p(b). Moreover, state courts generally have not recognized the doctrine of fraud-on-the-market in cases seeking relief under state common law, further limiting the state courts as an alternative forum for investors aggrieved by large-scale market manipulation of the sort alleged in this case. *See, e.g., Kaufman v. i-Stat Corp.*, 754 A.2d 1188, 1193-94 (N.J. 2000); *Mirkin v. Wasserman,* 858 P.2d 568, 584 (Cal. 1993).

Precisely because of the massive corporate frauds that have surfaced in recent years, some state courts have recognized the need to reevaluate barriers to civil actions alleging securities fraud. The California Supreme Court, for example, has cited the troubling increase in corporate fraud as a reason to recalibrate the balance between the interests of investors and the interests of corporations, in favor of providing greater judicial recourse to victims of fraud:

> When Congress enacted the Private Securities Litigation Reform Act of 1995 and the Uniform Standards Act of 1998, it was almost entirely concerned with preventing nonmeritorious suits. (Stout, supra, 38 Ariz. L. Rev. 711). But events since 1998 have changed the perspective. The last few years have seen repeated reports of false financial statements and accounting fraud, demonstrating that many charges of corporate fraud were neither speculative nor attempts to extort settlement money, but were based on actual misconduct. "To open the newspaper today is to receive a daily dose of scandal, from Adelphia to Enron and beyond. Sadly, each of us knows that these newly publicized instances of accounting-related securities fraud are no longer out of

> the ordinary, save perhaps in scale alone." (Schulman, et al., The Sarbanes-Oxley Act: The Impact on Civil Litigation under the Federal Securities Laws from the Plaintiff's Perspective (2002 ALI-ABA Cont. Legal Ed. p.1.) The victims of the reported frauds, moreover, are often persons who were induced to hold corporate stock by rosy but false financial reports, while others who knew the true state of affairs exercised stock options and sold at inflated prices. (See Purcell, The Enron Bankruptcy and Employer Stock in Retirement Plans, Congressional Research Service (Mar. 11, 2002)). Eliminating barriers that deny redress to actual victims of fraud now assumes an importance equal to that of deterring nonmeritorious suits.

See Small v. Fritz Companies, Inc., 65 P.3d 1255, 1263-64 (Cal. 2003) (a person wrongfully induced to hold stock may bring an action for fraud under state common law). However, unless and until this shift in state law gains currency, investors must depend upon the federal courts to afford complete relief where corporate executives and others have perpetrated a fraud on the market. As financial crimes abound and as alternative forums for aggrieved investors remain limited, it is especially important that the federal courts interpret federal law in a way that, to the extent possible, affords meaningful remedies to victims of securities fraud. The Seventh Circuit's ruling accomplishes this objective and should be affirmed.

II. THE TEST ADVANCED BY THE PETITIONERS FINDS NO SUPPORT IN THE REFORM ACT; IT CONFLICTS WITH RULE 12(b)(6) AS WELL AS THE SEVENTH AMENDMENT; AND IT AGGRAVATES RATHER THAN AMELIORATES THE ALREADY EXCESSIVE BURDENS FACING INJURED INVESTORS SEEKING REDRESS IN THE COURTS

The Petitioners argue that the "strong inference" standard requires courts to apply a host of additional tests to determine

if a complaint adequately pleads scienter under the Reform Act. At the heart of the Petitioners' argument is the notion that a court must exclude the possibility of innocence by entertaining inferences that favor the *defendant* as well as the plaintiff, and balancing those inferences to determine which are more plausible—those that indicate innocence or those that support culpability. *See, e.g.*, Brief of Petitioners, No. 06-484, 2007 WL 432763 at *25-26 (S.Ct. Feb. 9, 2007) ("Reform Act requires the complaint to paint a detailed picture of the facts that meaningfully tends to exclude the possibility of innocence. . . . "); *id.* at 35 (inference cannot be strong if claimed culpable inference appears no more plausible than alternative, innocent inferences). This standard, however, finds no support in the language or the legislative history of the Reform Act. Moreover, it conflicts with the time-honored principle that on a motion to dismiss, *all* reasonable inferences are to be drawn in favor of the plaintiff. It also violates the right to trial by jury by asking courts to choose between competing factual interpretations. Finally, and perhaps most important, the Petitioners' harsh formula undermines the policies that the Reform Act and the securities laws more generally were intended to serve: it will routinely extinguish meritorious fraud claims at the pleading stage without significantly enhancing the goal of discouraging frivolous suits.

A. The Language And The Legislative History Of The Reform Act Do Not Support The Petitioners' Interpretation Of The Pleading Standard

Nowhere does the Reform Act make any reference to drawing inferences that favor the defendant, balancing competing inferences regarding scienter, or excluding the possibility of innocence. As discussed above, a complaint satisfies the Act if it pleads facts giving rise to a strong inference of scienter. The legislative history also contains no hint that Congress intended to incorporate the Petitioners'

burdensome standard into the Reform Act. On the contrary, as discussed *supra*, the Conference Report disavows any Congressional intent to incorporate specific requirements other than the "strong inference" test.

B. The Pleading Standard Advanced By The Petitioners Conflicts With The Judicially Established Procedures For Applying Rule 12(b)(6)

An enormous body of case law developed under Rule 12(b)(6) of the Federal Rules of Civil Procedure, FED. R. CIV. P. 12(b)(6), has established three core principles that apply whenever a court entertains a motion to dismiss for failure to state a claim upon which relief can be granted. First, the complaint is construed in the light most favorable to the plaintiff. Second, the allegations as pled in the complaint are taken as true. Third, and most important for the purposes of this appeal, all reasonable inferences that can be drawn from the pleading are drawn in favor of the pleader. 5B CHARLES ALLEN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE §1357 (3d ed. 2004). When considering a motion to dismiss pursuant to Rule 12(b)(6), a court is bound to "assume the truth of all well-pleaded facts and indulge all reasonable inferences that fit the plaintiff's stated theory of liability." *See In re Colonial Mortg. Bankers Corp.*, 324 F.3d 12, 15 (1st Cir. 2003). The rationale for this doctrine is that, on a motion to dismiss, the court is not weighing evidence, but only testing the legal sufficiency of the plaintiff's claim to determine if relief may be granted. *See Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1187 (10th Cir. 2003). This Court has instructed that "a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). This instruction leaves no room for

the trial judge to consider the inferences that cast a defendant in the best light.

Congress evinced no intent to amend Rule 12(b)(6) or overturn its judicial underpinnings when it adopted the Reform Act. "[T]he Reform Act did not reverse the polarity of securities pleading." *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001), *cert. dismissed*, 536 U.S. 935 (2002). In the absence of such an amendment, federal courts are bound to follow the dictates of Rule 12(b)(6). *See Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163 (1993). Accordingly, its requirements apply no less to allegations of scienter in a securities fraud case than they do to any other case. The Petitioners' assertion that on a motion to dismiss, courts must entertain inferences in favor of the defendant directly conflicts with the canons of Rule 12(b)(6). The Seventh Circuit's interpretation of the pleading standard for scienter creates no such conflict, and for this reason, the court's ruling should be affirmed.

C. The Petitioners' Insistence That Courts Balance Competing Inferences To Resolve A Motion To Dismiss Conflicts With The Seventh Amendment's Right To Trial By Jury

The Seventh Amendment to the Constitution provides that "the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise reexamined in any Court of the United States, than according to the rules of the common law." U.S. CONST. amend. VII. It is well settled that "when there is a debatable issue of fact in the trial of a suit at common law in a court of the United States, the right to have it determined by a jury is guaranteed by the Seventh Amendment of the Constitution." *See Hunt v. Bradshaw*, 251 F.2d 103, 108 (4th Cir. 1958). The Seventh Amendment ensures "the enjoyment of the right of trial by jury be not obstructed, and that the ultimate determination of issues of fact by the jury be not interfered with." *Ex Parte Peterson*, 253 U.S.

300, 309-310 (1920). "[M]aintenance of the jury as a fact-finding body is of such importance and occupies so firm a place in our history and jurisprudence that any seeming curtailment of the right to a jury trial should be scrutinized with the utmost care." *Beacon Theatres, Inc. v. Westover*, 359 U.S. 500, 501 (1959).

The right to trial by jury places limits on the nature of the issues that a judge may decide on a dispositive motion, such as a motion to dismiss or a motion for summary judgment. Courts certainly are empowered to make procedural rulings with a view to formulating the issues. However, when a court weighs competing inferences and "fails to draw all reasonable inferences in favor of [the plaintiff]," it acts as a fact finder and "impermissibly substitute[s] its judgment concerning the weight of the evidence for the jury's." *Reeves v. Sanderson Plumbing Products*, 530 U.S. 133, 153 (2000); *cf. Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 255 (1986) ("Credibility determinations, the weighing of the evidence and the drawing of legitimate inferences from the facts are jury functions, not those of a judge, whether ruling on a motion for summary judgment or for a directed verdict.").

The Petitioners' interpretation of the Reform Act calls upon courts to engage in just these sorts of factual determinations: considering the relative weight of inferences drawn in favor of both parties, in conflict with the Seventh Amendment. The Seventh Circuit recognized the constitutional implications of the Petitioners' test:

> [W]e think it wiser to adopt an approach that cannot be misunderstood as a usurpation of the jury's role. Instead of accepting only the most plausible of competing inferences as sufficient at the pleading stage, we will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent. "Faced with two seemingly equally strong inferences, one favoring the plaintiff

> and one favoring the defendant, it is inappropriate for us to make a determination as to which inference will ultimately prevail, lest we invade the traditional role of the factfinder."

See Makor, 437 F.3d at 602 (quoting *Pirraglia*, 339 F.3d at 1188); *see also City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 683 n.25 (6th Cir.), *cert. denied*, 126 S.Ct. 423 (2005) ("One might argue that for cases where a juror could conclude that the facts pleaded show scienter, but that conclusion would not be the most plausible of competing inferences, a Seventh Amendment problem is presented."). Unlike the Petitioners' test, the Seventh Circuit's interpretation of the Reform Act avoids a conflict with the right to trial by jury, and for this reason the court's ruling should be affirmed.

D. If The Seventh Circuit's Ruling Is Reversed, An Increasing Number Of Investors Will Suffer Irretrievable Losses At The Hands Of Those Committing Fraud

While the Seventh Circuit's ruling imposes manageable burdens on investors who have legitimate claims for securities fraud, the Petitioners' formula for pleading scienter under the Reform Act heaps additional, unreasonable requirements on those same investors. Under that formula, meritorious claims involving fraud on the market will be barred in instances where a class of plaintiffs, at the pleading stage and without the benefit of discovery, cannot yet perform the daunting task of disproving all innocent explanations for the defendants' fraudulent conduct. As a result, plaintiffs will be unjustly deprived of the right to recover damages for fraud and abuse that unquestionably caused them injury. Because the Petitioners' interpretation of the pleading requirements for scienter under the Reform Act will so undermine the purposes of the securities laws, and because it is neither compelled nor warranted by the applicable statutory language, it should be

rejected. The Seventh Circuit's ruling avoids this unfairness to investors, without betraying the obligation to fulfill Congress's policy objectives under the Reform Act, and it should therefore be affirmed.

CONCLUSION

For the reasons set forth above, the decision of the Seventh Circuit should be affirmed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

TELLABS, INCORPORATED and RICHARD C. NOTEBAERT,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*

Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR PIXELPLUS CO., LTD. AND QUEST SOFTWARE, INC. AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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BRIEF OF *AMICI CURIAE* IN SUPPORT OF PETITIONERS

This brief is filed on behalf of Pixelplus Co., Ltd. (Pixelplus), and Quest Software, Inc. (Quest) in support of petitioners, with the written consent of the parties.[1]

INTERESTS OF THE *AMICI CURIAE*

Amici are high technology companies currently defending their interests in separate securities class actions in New York[2] and California,[3] and would directly benefit from a uniform standard for pleading scienter consistent with the plain language and clear purpose of the Private Securities Litigation Reform Act of 1995 ("Reform Act"). Pub. L. No. 104-67, 109 Stat. 737 (1995).

[1] *Amici* affirm that no counsel for a party has written this brief in whole or in part and that no person or entity, other than the *Amici,* their members, or their counsel, has made a monetary contribution to the preparation and submission of this brief. *Amici* further state that they do not have parent corporations and that there is no publicly held company that owns 10% or more of the stock of Pixelplus or Quest.

[2] Pixelplus is a defendant named in a number of complaints filed in the Southern and Eastern Districts of New York that have yet to be consolidated which are based upon alleged misstatements made in its December, 2005 offering of American Depositary Shares in the United States.

[3] Quest is a defendant in the Central District of California in a case regarding its financial restatement relating to an options grant practice review.

Pixelplus, with headquarters in South Korea and subsidiaries in Northern California, China and Taiwan, designs, develops and markets images sensors and applications with a focus on the mobile handset market.

Quest, a California corporation with headquarters in Southern California and offices or distribution centers across the nation and sixty-four other countries, designs, develops, distributes and supports software products that improve the performance and productivity of its customers' packaged and custom software applications and associated software infrastructure components.

Amici compete in the volatile high-tech global marketplace which is characterized by complex, rapidly changing technologies and intense competitive pressures. To maintain a competitive position in this environment, companies expend far greater resources than is typical of other industries on research and development, marketing and distribution, which are necessary to enhance existing products and develop new products to address customer needs. As a result, companies such as these operate in volatile markets, and are especially vulnerable to the coercive nature of strike suits that have an effect of pressuring defendants to settle merit-less actions due to the high cost of litigation.

Amici offer guidance on matters that are of special concern to domestic and foreign issuers in emerging growth industries like the communications and software markets, and respectfully request that this Court reverse the court below and adopt a uniform standard effectuating the plain language and purpose of the Reform Act.

SUMMARY OF THE ARGUMENT

In the decade since Congress enacted the Reform Act, the courts of appeal have struggled to establish a uniform standard for pleading scienter. With the decision below, there are at least four different interpretations of the Reform Act's standard for pleading scienter.

Yet, despite this lack of uniformity, *all* federal courts of appeal – with the exception of the court below – allow some consideration of innocent inferences to determine whether plaintiffs have pled facts showing a strong inference of scienter. Indeed, beyond just considering innocent inferences, the plurality of courts of appeal have followed the Sixth Circuit's clear holding that only where a culpable inference of scienter is the "most plausible" to be drawn will a complaint withstand dismissal.

The Seventh Circuit's recent adoption of a "could infer" standard is by far the most lax standard among its sister circuits, not to mention pre-Reform Act standards. The court's refusal to allow courts to consider competing innocent inferences arising out of the alleged facts is contrary to the Reform Act's plain language which requires plaintiffs to plead a "strong inference" of scienter (15 U.S.C. § 78u-4(b)(2)), and deprives defendants of even the pre-Reform Act standards for pleading scienter generally.

The Seventh Circuit's "could infer" standard appeared to be motivated from the court's concern that the more rigorous standard followed by the plurality of other circuits – and required by the Reform's Act heightened standard – requires district courts to infringe upon the

jury's role as fact-finders by weighing all inferences that flow from the alleged facts. This concern, however, is unwarranted and ignores the body of common law that has required heightened pleading and proof for fraud, and under which many courts were required to consider evidence at summary judgment under a heightened "clear and convincing" standard.

Moreover, the Reform Act's heightened pleading burden for scienter is a procedural matter, and a question of law, and does not implicate the jury's fact-finding role. *See Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974), *overruled on other grounds*, *Harlow v. Fitzgerald*, 457 U.S. 800 (1982) (finding that the Constitutional right to a jury trial is not implicated at the motion to dismiss stage because "the issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims"); *see also Baltimore & Carolina Line, Inc. v. Redman*, 295 U.S. 654, 657 (1935) (noting that the Seventh Amendment is not implicated where matters of procedure and issues of law are concerned). In addition, Congress was well within its power to impose higher pleading requirements for securities cases than those generally required in Rule 9(b) or 12(b)(6) of the Federal Rules of Civil Procedure. *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 512-13 (2002); *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 168 (1993).

The "could infer" standard also runs counter to the Reform Act's clear purpose of discouraging strike suits[4] that, if allowed to move forward, present companies with a Hobson's choice of paying the high cost to defend a meritless suit versus settling up front for a nuisance value, and will likely result in higher defense and insurance costs.[5] This environment is also more likely to force foreign issuers to withdraw prematurely their listings within markets in the United States, depriving issuers from sources of capital, issuer employees from a form of compensation and public investors from investment alternatives.[6] This increased burden on valued and significant segments of the economy, as well as this Court's recent admonition against using the securities laws as a form of secondary insurance,[7] reason in favor of rejecting the Seventh Circuit's "could infer" standard.

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[4] *See* S. Rep. No. 104-98, at 4, reprinted in 1995 U.S.C.C.A.N. 679, 683. (noting that the Reform Act has the purpose of discouraging strike suits containing claims that were often "based on nothing more than a company's announcement of bad news, not evidence of fraud").

[5] *See* S. Rep. No. 104-98, at 9, reprinted in 1995 U.S.C.C.A.N. 679, 688 (observing that prior to the Reform Act, defendants often settled quickly regardless of merit in order to avoid the expense and risk of litigation); *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 347-48 (2005).

[6] *See* S. Rep. No. 104-98 at 4, *reprinted in* 1995 U.S.C.C.A.N. 679, 683 (noting that the resulting expense of strike suites was borne indirectly by the capital markets by imposing increased costs on capital formation to the detriment of investors and companies in the United States).

[7] *Dura*, 544 U.S. at 347-48 (rejecting a rule for pleading loss causation that "would tend to transform a private securities action into a partial downside insurance policy.") (citations omitted).

The fundamental unsoundness of the Seventh Circuit's approach is underscored by the strategic ambiguities it encourages plaintiffs to create in their complaints to a state a claim in even the weakest case. As the hypothetical discussed below helps to show (*infra at* 13-15), the Seventh Circuit's "could infer" rule invites speculation, and reads the heightened pleading requirement out of the statute. This is contrary to the plain language of the Reform Act and would allow a standard even more lax than that in place prior to the Reform Act to govern cases brought within the Seventh Circuit. This is precisely the type of disparate result the Reform Act was designed to address.

Given the disparity in approaches by the courts of appeal, a uniform rule is needed to establish the uniformity the Reform Act was enacted to create. *See* H.R. Rep. No. 104-369, at 41, *reprinted in* 1995 U.S.C.C.A.N. 730, 740 (explaining that one of the purposes of the Reform Act is to create "uniform and more stringent pleading requirements"). The plurality of circuits have already adopted a rule which carries out the plain language and purpose of the Reform Act and that standard should be adopted as the uniform rule.

ARGUMENT

I. THE SEVENTH CIRCUIT'S "COULD INFER" STANDARD IS INCONSISTENT WITH THE REFORM ACT'S PLAIN LANGUAGE

The Seventh Circuit has adopted a "could infer" scienter pleading standard that is irremediably at odds with the Reform Act. As this Court explained in *Dura*

Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005), the Reform Act "insists that securities fraud complaints . . . 'state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.'" 544 U.S. at 345-46 (quoting 15 U.S.C. § 78u-4(b)(1), (2)).

As *Dura* recognized, the plain language of the Reform Act requires that plaintiffs plead a "strong inference" of scienter, which in turn requires district courts to weigh competing inferences to determine whether combined inferences in favor of scienter are "strong." The Reform Act's plain language thus requires a district court do more than simply accept the inferences that "could" plausibly be drawn from plaintiff's allegations. For if only inferences favorable to plaintiff could ever be considered, how then would a district court ever conclude that they were not strong?

For example, in the vast majority of cases a CEO who was committing fraud would never buy massive amounts of stock during the class period. It is remotely conceivable, however, that a CEO could sacrifice his personal wealth to cover up a fraud at the company. Confronted with the competing inferences that can be drawn from the same alleged fact, the decision below veritably requires courts to infer a cover-up (a weighty inference indeed to any CEO who, in all probability, stands wrongly accused), because every inference that could be drawn from the stock purchases must be drawn in the plaintiff's favor.

In this regard, the Seventh Circuit's decision would impermissibly read the heightened pleading requirement

out of the statute, and would impose a standard even more lax than in pre-Reform Act cases. In essence, the "could infer" standard is a "can't miss" for plaintiffs. It was never the law that the district courts would infer anything they could infer in favor of a complaint, no matter how implausible. *Reasonable* inferences were always to be drawn even in pre-Reform Act times – including in the Seventh Circuit. *See, e.g.*, *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (holding that even under Rule 9(b), conclusory allegations are insufficient, and cautioning courts not to "indulg[e] ready inferences of irrationality"); *Kowal v. MCI Commc'ns, Corp.*, 16 F.3d 1271, 1276 (D.C. Cir. 1994) (affirming dismissal and explaining, "the court need not accept inferences drawn by plaintiffs if such inferences are unsupported by the facts"); *cf. Melder v. Morris*, 27 F.3d 1097, 1102 (5th Cir. 1994) (rejecting conclusory motive allegations regarding defendants' position or compensation as this "would effectively eliminate the state of mind requirement" in "'a nihilistic approach to Rule 9(b) jurisprudence'" and ruling that absent adequate motive allegations, plaintiffs must "face a tougher standard for establishing fraudulent intent").

II. THE "MOST PLAUSIBLE" STANDARD ADOPTED BY THE PLURALITY OF COURTS CONFORMS TO THE REFORM ACT'S PLAIN LANGUAGE AND STATUTORY PURPOSE

A. The "Most Plausible" Test is Supported by the Plain Language of the Statute

The plurality of circuits permit district courts to consider innocent inferences in determining whether plaintiffs have pled facts giving rise to a strong inference of

scienter. The Sixth Circuit was the first to articulate what has become the plurality rule that the Reform Act entitles plaintiffs "only to the most plausible of competing inferences" from the facts alleged in the complaint, and explained that this standard derives from the Reform Act and "represents a significant strengthening of the pre-[Reform Act] standard under Rule 12(b)(6)." *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001).

Following the Sixth Circuit's decision in *Helwig*, three of its sister circuits adopted the same "most plausible" standard. *See In re Credit Suisse First Boston Corp. Analyst Reports Sec. Litig.*, 431 F.3d 36, 49 (1st Cir. 2005); *Ottman v. Hanger Orthopedic Grp., Inc.*, 353 F.3d 338 (4th Cir. 2003); *Gompper v. VISX, Inc.*, 298 F.3d 893 (9th Cir. 2002).

Even the Ninth Circuit – which prior to the Reform Act arguably had the most lenient standard for pleading a securities fraud claim – followed the Sixth Circuit's "most plausible" test, holding that the court should consider "any reasonable inferences that can be drawn" from scienter allegations. *Gompper*, 298 F.3d at 896-97.

The Ninth Circuit squarely rejected the claim that innocent inferences at the pleading stage can be ignored, explaining that this approach would "eviscerate the [Reform Act's] strong inference requirement by allowing plaintiffs to plead in a vacuum." *Id.* Indeed, the court reasoned that because the statute's plain language "made it crystal clear that the [Reform Act's] pleading requirements were put in place so that only complaints with particularized facts giving rise to a strong inference of wrongdoing survive," a district court "*must* consider *all*

reasonable inferences . . . including inferences unfavorable to the plaintiffs." *Id.* (emphasis added).

In stark contrast, the Seventh Circuit below adopted an expansive "could infer" standard that rejects the plurality rule and disregards the plain language of the Reform Act. This Court should confirm the Reform Act's basic standard that a strong inference of scienter must be established by alleging facts requiring that the culpable inference give rise to a "strong inference" of scienter – or as the plurality would state, is the "most plausible" one.

B. The "Could Infer" Standard Would Produce Unreasonable Results and Undermine the Statutory Purpose

The Ninth Circuit properly characterized the type of standard ultimately adopted by the Seventh Circuit as "thwart[ing] Congress's basic purpose in raising the bar in the first place; namely, to eliminate abusive and opportunistic securities litigation and to put an end to the practice of pleading fraud by hindsight." *Gompper*, 298 F.3d at 896-97. To this end, the Seventh Circuit's "could infer" rule undermines the Reform Act's express goal of preventing vexatious private securities litigation by enabling plaintiffs to resort to the type of ambiguous and conclusory allegations that the Reform Act is designed to prevent. As this Court cautioned in *Dura*, lax pleading standards pose a coercive threat to defendants because a plaintiff "with a largely groundless claim [could] . . . simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value." *Dura*, 544 U.S. at 347-48 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741

(1975)). Tolerating such lax pleadings in the loss causation context would "tend to transform a private securities action into a partial downside insurance policy." *Id.* (citations omitted). Ironically, the Seventh Circuit itself also has recognized this fact: "[S]ettlements in securities cases reflect high risk of catastrophic loss, which together with imperfect alignment of managers' and investors' interests leads defendants to pay substantial sums even when the plaintiffs have weak positions." *West v. Prudential Sec., Inc.*, 282 F.3d 935, 937 (7th Cir. 2002).

In *Gompper*, the Ninth Circuit further demonstrated the absurd result that could have been reached in that case by excluding innocent inferences from the facts alleged in the complaint, a result that would have undermined the purposes of the Reform Act:

> [T]he complaint sets out in great detail VISX's tendency to sue its competitors for patent infringement. Plaintiffs argue that one reasonable and warranted inference one could draw from VISX's litigation pattern is that VISX knew its patents were invalid and, consequently, engaged in an aggressive strategy of intimidation through litigation. . .
>
> Of course, ***it is equally if not more plausible*** that VISX consistently initiated litigation in defense of its patents because it and its officers believed the patents were valid, and recognized that the very survival of VISX's business model was contingent on the technology protected by these patents. ***Consideration of this inference quite***

> ***clearly impedes the plaintiffs' progress toward building the requisite strong inference of scienter.***

Gompper, 298 F.3d at 896-97 (emphasis added).

The "most plausible" standard thus best effectuates the clearly articulated heightened pleading standard under the Reform Act by requiring plaintiffs to live with all of the inferences – good and bad – created by the allegations they choose to include in the complaint.

The Seventh Circuit's "could infer" is the most lenient of any circuit and would encourage rather than diminish securities complaints supported only by conjectural claims of scienter. Consider how the following hypothetical case (based, however, on real world experience of many public companies) could well be resolved differently under the "could infer" versus the "most plausible" standard:

- **Hypothetical:**

Plaintiffs' Complaint alleges that the CEO of Company X made material misstatements concerning the financial health of Company X. Plaintiffs allege that the CEO sold 3 million shares of stock during the class period of sixteen months which was alleged to be unusual and suspicious. But the pleadings or judicially noticeable documents and facts also show (1) that his holdings in Company X during the relevant time period were in excess of 60 million shares (i.e., the sale of 3 million shares represented only 5% of his stock holdings in Company X during the class period), (2) that the 3 million shares of

stock were sold pursuant to a previously disclosed and non-discretionary Rule 10b5-1 plan, and (3) that the CEO actually purchased 6 million shares toward the end of the class period. With regard to this last fact, Plaintiffs allege without further factual support that the purchase was made to cover up the CEO's participation in the alleged fraud.

(a) Result Under the "Could Infer" Standard?

Under the Seventh Circuit's "could infer" approach, it is possible that the district court only should consider the sales of stock, not the percentage of sales or their non-discretionary nature. It might also be possible under this standard that the district court, while finding it very unlikely, "could infer" that the purchases were part of a cover up. In that case, the overwhelmingly reasonable inferences that might be drawn about the CEO's innocent mental state due to minimal stock sales, purchases of twice as many shares, and the Rule 10b5-1 plan are excluded as allegedly improper, and only the fact that the CEO sold stock and perhaps attempted some cover up is considered. Since stock sales by officers during an alleged class period are often seen by courts as strong evidence of scienter, the complaint may survive a motion to dismiss. Presumably evidence of a "cover up" via purchases would also raise some inference of scienter.

(b) Result Under the "Most Plausible" Standard?

In contrast, the plurality of circuits would not only consider the innocent inferences created by the CEO's stock holdings during the class period and the non-

discretionary nature of the sales made as part of a disclosed Rule 10b5-1 plan, they would find that the remaining culpable inferences of insider trading are not the "most plausible" inference from the facts and would accordingly grant the CEO's motion to dismiss. *See In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999); *see also In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1094-95 (9th Cir. 2002); *Ronconi v. Larkin*, 253 F.3d 423, 435 (9th Cir. 2001); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197-98 (1st Cir. 1999).

Similarly, the plurality's "most plausible" standard would clearly find that the CEO's purchase of shares during the class period tends to negate scienter. *See, e.g., In re First Union Corp. Sec. Litig.*, 128 F. Supp. 2d 871, 899 (W.D.N.C. 2001) (an insider's purchase of stock during the class period "is wholly inconsistent with [plaintiffs'] contention that he knew undisclosed negative information about the Company"); *see also, In re Advanta Corp. Sec. Litig.*, 180 F.3d 525 (3d Cir. 1999) (holding that the sale of no stock during the class period by three insiders negates an inference of scienter); *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995) ("The fact that the other defendants did not sell their shares during the relevant class period undermines plaintiffs' claim that defendants delayed notifying the public so that they could sell their stock at a huge profit." (internal quotations omitted)).

In sum, allowing plaintiffs to exclude the innocent inferences stemming from these facts improperly permits an end-run around the reforms Congress enacted over a decade ago and should be rejected in favor of the "most plausible" standard.

III. THE REFORM ACT'S HEIGHTENED PLEADING STANDARD PARALLELS THE STANDARD IN SIMILAR COMMON LAW FRAUD CASES WHICH HAVE NEVER RAISED CONSTITUTIONAL CONCERNS

In adopting the "could infer" standard, the Seventh Circuit appeared concerned that the more rigorous standard followed by other circuits somehow would infringe upon the Constitutional right to a jury trial by requiring the district courts to engage in fact-finding. But any such concern ignores the fact that heightened pleading and proof always has been required at common law for frauds of all types, and that, for example, district courts for many years have had to measure evidence at summary judgment against a heightened "clear and convincing" standard for common law fraud.

As this Court noted in *Dura*, because the right to bring a securities fraud action is implied under the statute, courts properly may look to the common law for guidance. *Dura*, 544 U.S. at 341, 346. Moreover, the Reform Act "makes clear Congress' intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss." *Id.* at 346. Just as traditional elements of causation and loss apply for purposes of determining whether plaintiffs have pled the element of loss causation, traditional elements of deceit and misrepresentation likewise apply. *Id. at* 341 (citing *Blue Chip Stamps*, 421 U.S. at 730, 744; *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976)). To this end, both the securities fraud claims and the common law claims require the plaintiff establish certain identical elements, including material

misrepresentation, justifiable reliance and causation. *Id.* at 343-44 (citing Restatement (Second) of Torts § 525, p. 55 (1976)).

For many years, a majority of common law jurisdictions have required plaintiffs pleading fraud to establish their claims by clear and convincing evidence.[8] And, certain jurisdictions which do not require clear and convincing proof still require something more than a preponderance of the evidence.[9]

Congress' enactment of a requirement that a securities fraud plaintiff plead a "strong inference of scienter" is well in keeping with this common law tradition of heightened proof of fraudulent conduct. And, to the best of *Amici*'s understanding, it has never been of Constitutional concern that district courts considering common law fraud claims would examine the facts at, for example, a summary judgment stage, to see if they met these types of heightened standards for fraud. Only by such measuring could the courts determine whether or not the evidence met a clear and convincing standard.

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[8] *See, e.g., Ross v. Powell*, 206 S.W. 3d 327 (Ky. 2006); *Carrillo v. Fabian*, 701 N.W.2d 763 (Minn. 2005).

[9] *See, e.g., Arnett v. Sanderson*, 218 P. 986, 990 (Ariz. 1923) (while "proof of fraud should be clear and convincing ... fraud is determined by a preponderance of the evidence"). Other states require plaintiff to prove common law fraud by a preponderance of the evidence. *See, e.g., Travelers Indem. Co. v. Armstrong*, 442 N.E. 2d 349 (Ind. 1982) (also holding that fraud in cases of equity must be shown by clear and convincing evidence).

CONCLUSION

For the reasons presented above, the judgment of the court of appeals should be reversed, and the case remanded.

Respectfully submitted.

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IN THE

Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF FOR THE REGENTS OF THE UNIVERSITY OF CALIFORNIA, THE CALIFORNIA PUBLIC EMPLOYEES RETIREMENT SYSTEM, AND PROFESSORS JAMES D. COX, RICHARD M. BUXBAUM, JILL E. FISCH, C. HUGH FRIEDMAN, FRANK PARTNOY, MARC I. STEINBERG, AND MELVIN E. EISENBERG AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED

Whether the Private Securities Litigation Reform Act's requirement that to plead a claim of securities fraud plaintiff must state with particularity facts raising a "strong inference" that defendant acted with scienter changed long-established Rule 12(b)(6) jurisprudence that, in considering a motion to dismiss, the court must not only accept all well-pled facts, but must draw all reasonable inferences in plaintiff's favor to determine whether rational jurors could find from the collective allegations that the defendant acted with the required state of mind.

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INTEREST OF *AMICI CURIAE* [1]

The Regents of the University of California ("The Regents"), and the California Public Employees Retirement System ("CalPERS"), are institutional investors in publicly traded securities that have a strong interest in ensuring the integrity and transparency of U.S. securities markets. Their experience as lead plaintiff in securities class actions will assist the Court in evaluating the policy implications of its decision. Professors James D. Cox, Richard M. Buxbaum, Jill E. Fisch, C. Hugh Friedman, Frank Partnoy, Marc I. Steinberg, and Melvin E. Eisenberg, are corporate, securities and civil procedure law specialists with strong interests in ensuring that U.S. securities laws and procedures are consistently and fairly applied to protect investors from fraudulent practices. A brief description of each of the *amici* follows:

1. Article IX, section 9 of the California Constitution grants The Regents "full powers of organization and government" over the University of California. As fiduciary for the University's pension and endowment funds for nearly 500,000 active and retired participants, The Regents' assets of $66 billion include substantial investments in publicly traded securities. In 2002, The Regents were appointed lead plaintiff in the class suit involving Enron Corporation. *Newby v. Enron Corp.* (*In re Enron Corp. Sec. Litig.*), 206 F.R.D. 427 (S.D. Tex. 2002).

2. CalPERS is the largest public pension plan in the United States. It provides retirement and health benefits to 1.5 million public employees, retirees and their families.

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[1] This brief was not authored, in whole or in part, by counsel for either party, and no person or entity other than *amici*, their members and their counsel contributed monetarily to the submission of the brief. The parties' general letters of consent to the filing of *amicus* briefs have been filed with the clerk. Prior to May 2004, certain partners in the firm representing *amici* were partners in the firm representing respondents when this action was initiated, but neither they nor their firm have any economic interest in the outcome of this litigation.

CalPERS is the fiduciary for the California state employee pension fund, with some $223 billion in assets, including substantial investment in publicly traded U.S. securities. CalPERS has served as lead plaintiff representing classes of investors in several cases, as follows: *In re Cendant Corp. Sec. Litig.*, No. 98 Civ. 1664-WHW (D.N.J.); *California Public Employees' Retirement System v. Chubb Corp.*, No. 00 Civ. 4285-GEB (D.N.J.); *In re NYSE Specialist Sec. Litig.*, No. 03-Civ. 8264-RWS (S.D.N.Y.); *California Public Employees' Retirement System v. United Health Group, Inc.*, No. 06 Civ. 2939-JMR/FLN (D. Minn.).

3. Professor James D. Cox joined the faculty of the School of Law at Duke University in 1979 where he specializes in corporate and securities law. Professor Cox earned his law degree at the University of California, Hastings College of the Law (J.D.) and Harvard Law School (LL. M.). In addition to his texts *Cox and Hazen on Corporations*; and *Securities Regulations Cases and Materials* (with Professors Hillman & Langevoort), Professor Cox has published extensively in the areas of market regulation and corporate governance as well as having testified before Congress on insider trading and market reform issues. He is a former member of the New York Stock Exchange ("NYSE") Legal Advisory Committee and a member of the National Association of Securities Dealers ("NASD") Legal Advisory Board.

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The issue in this case concerns the interpretation of the Private Securities Litigation Reform Act ("PSLRA") "strong inference" pleading standard. If that standard is interpreted to change the usual practice under Federal Rule of Civil Procedure 12(b)(6) that courts draw all reasonable inferences from the complaint in plaintiff's favor, to allow the weighing of competing inferences and explanations, it could seriously impair the ability of hundreds of thousands of middle class employees, retirees, and their families, whom the institutional *amici* represent, to recover devastating losses caused by fraud.

Meritorious private actions, including those brought by institutions, are an essential component of the enforcement of the securities laws. Indeed, the PSLRA was designed to encourage institutional investors to serve as lead plaintiffs in securities class actions as an important means of ensuring meritorious suits and eliminating non-meritorious ones. Recent studies confirm that the increased role of institutional investors as lead plaintiffs has resulted in fewer and better securities suits. The Economist, *Classier actions* (Feb. 15, 2007).

SUMMARY OF ARGUMENT

In making a Rule 12(b)(6) motion to dismiss, defendants necessarily admit all well-pled allegations and all inferences a jury can reasonably draw in plaintiff's favor, and assert nonetheless that no claim for relief is stated. These basic assumptions are 200 years old. As Chief Justice Marshall explained: "The party demurring admits the truth of the testimony to which he demurs and also those conclusions of fact which a jury may fairly draw from the testimony." *Pawling v. United States*, 8 U.S. [4 Cranch] 219, 221-22 (1808). Thus, a Rule 12(b)(6) motion tests plaintiff's best case to determine whether—as a matter of law—he states a claim. *Scheuer v. Rhodes,* 416 U.S. 232, 236 (1974). The court does not sit as a fact finder to weigh defendants' explanations.

Neither petitioners nor any of their *amici* save one even mention Rule 12(b)(6). They doubtless prefer that this Court disregard it. Instead, they rely entirely on the PSLRA. But, in enacting the PSLRA, Congress did not address, let alone amend the essential premises of Rule 12(b)(6). Congress simply provided that to state a claim for securities fraud, the "complaint" must "state with particularity" facts giving rise to a "strong inference that the defendant acted with the requisite state of mind." 15 U.S.C. §78u-4(b)(2). The PSLRA did not empower courts to draw inferences adverse to plaintiff or weigh competing explanations. Any such change in the "usual practice under the Federal Rules" must be obtained by amending the Rules, "not by judicial interpretation." *Jones v. Bock*, __ U.S. __, 127 S. Ct. 910, *25 (2007).

Further, this Court's decision in *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242 (1986) explains why the PSLRA's heightened "strong inference" standard is not inconsistent with the inference-drawing assumptions of Rule 12(b)(6). On a dispositive motion, the court views the facts "through the prism of the substantive evidentiary burden" (*Id.* at 254), but:

> Credibility determinations, the weighing of evidence, and the drawing of legitimate inferences from the facts

> are jury functions, not those of a judge, whether he is ruling on a motion for summary judgment or for a directed verdict. The evidence of the nonmovant is to be believed, and all justifiable inferences are to be drawn in his favor.

Id. at 256; *accord Reeves v. Sanderson Plumbing Products, Inc.*, 530 U.S. 133, 150-52 (2000).

Liberty Lobby also makes clear that a judge's determination of a dispositive motion "unavoidably asks whether reasonable jurors could find by a preponderance of the evidence" for the plaintiff. *Id.* at 252. In this case, the Seventh Circuit correctly applied a test that is mandated by *Liberty Lobby*. The Seventh Circuit held that the pleadings are to be judged by whether "a reasonable person could infer that the defendant acted with the required intent." (App. 20a) Thus, contrary to petitioners and their *amici*, the Seventh Circuit did not ignore the PSLRA "strong inference" standard or dilute it to a reasonable inference; it simply applied this Court's "reasonable jurors" approach from *Liberty Lobby*.

In light of its evident relevance here, it is startling that neither petitioners nor the SEC even cite *Liberty Lobby*. Two of petitioners' *amici* (Washington Legal Foundation and American Institute of Certified Public Accountants) do cite it, but only for the proposition that an elevated standard may apply to dispositive motions (WLF Br. 17, 20 n.9, AICPA Br. 18). These *amici* ignore *Liberty Lobby's* holding that plaintiffs are still entitled to "all justifiable inferences."

The PSLRA "was not enacted to raise the pleading burdens" to a level that "facially valid claims" must be "routinely dismissed." *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 354 (5th Cir. 2002). The PSLRA contains ample safeguards to achieve its goal of curbing pleading abuse without rewriting long-established Rule 12(b)(6) jurisprudence. In addition to the "***strong inference***" standard, the statute requires that falsity and scienter be alleged with "***particularity***," and that plaintiff plead with particularity a

factual basis for information and belief allegations from witness or document sources. 15 U.S.C. §78u-4(b)(1), (2).

Petitioners and their *amici* overlook that, since 1995, securities litigation has been taken over by respected institutional investors, such as the *amici* on this brief, who meet the lead plaintiff qualifications of the PSLRA. 15 U.S.C. 78u-4(a)(3)(B). The parade of horribles petitioners portray ignores the reality that there are fewer class actions today, and they are better led and better pled. The Economist, *Classier actions* (Feb. 15, 2007).

"Given the complexity of modern securities markets," pleading and proving the elements of a §10(b) claim "may be difficult." *Lampf v. Gilbertson*, 501 U.S. 350, 377 (1991) (Kennedy, J. dissenting). Because private §10(b) actions are "an essential component of the protection the law gives to investors who have been injured by unlawful practices" (*Id.* at 374), raising the bar even higher than provided in the PSLRA "will 'thwart the legislative purpose of creating an effective remedy' for victims of securities fraud." *Id.* at 377. "Unless reasonable inferences from circumstances suffice to get a case to a jury, the welfare of victimized investors and the integrity of the stock market may be insufficiently protected from deceptive manipulators." *Ronconi v. Larkin*, 253 F.3d 423, 428 (9th Cir. 2001).

Though plaintiff's underlying inferences must be reasonable, only the ultimate inference of scienter, based on the "totality" of facts and justifiable inferences drawn, must "collectively add up to a strong inference." *See, e.g., Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 660 (8th Cir. 2001); *In re Cabletron Systems Inc.*, 311 F.3d 11, 42 (1st Cir. 2002). In offering definitions of "strong inference," however, petitioners and their *amici* aggressively push to elevate the standard even further suggesting that plaintiff's allegations must be "compelling" and "leave little room for doubt" and even "exclude the possibility of inno-

cence." (Pet. Br. 25, 34) They ignore the Second Circuit jurisprudence, which created the "strong inference" standard, and defined it to mean sufficient facts pled from which a jury could find "more likely than not" that defendant acted with scienter. *Cohen v. Koenig*, 25 F.3d 1168, 1174 (2d Cir. 1994). That definition is consistent with this Court's "preponderance of evidence" standard for securities cases. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 (1983). Neither petitioners nor the SEC mention *Huddleston* either.

Further, contrary to petitioners' count (Petition 4, 17), only the Sixth and Ninth Circuits hold that the PSLRA permits courts to weigh inferences adverse to plaintiffs. All other circuits, including the Seventh Circuit here (App. 7a, 20a-21a), continue to recognize that under Rule 12(b)(6) plaintiffs are entitled to all reasonable inferences, provided the facts are alleged with particularity. *See, e.g., In re Rockefeller Center Properties, Inc. Sec. Litig.*, 311 F.3d 198, 224 (3d Cir. 2002); *Pirraglia v. Novell*, 339 F.3d 1182, 1188 (10th Cir. 2003). More specifically, the First Circuit held it was error under Rule 12(b)(6) to draw "inferences in the defendant's favor." *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 79 (1st Cir. 2002).

In sum, petitioners' theory that inferences adverse to plaintiff may be drawn should be rejected. It not only violates Rule 12(b)(6), but would impair private securities litigation as "an indispensable tool with which defrauded investors can recover their losses without having to rely on government action" which Congress retained in enacting the PSLRA. H.R. Conf. Rep. 104-369, at *31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730; *Huddleston*, 459 U.S. at 390 (defrauded investors are "the very individuals Congress sought to protect").

ARGUMENT

I. In Making a Rule 12(b)(6) Motion, a Defendant Necessarily Admits All Well-Pled Facts and Reasonable Inferences Drawn in Plaintiff's Favor, and Asserts Nonetheless that No Claim Is Stated

The jurisprudential basis of a Rule 12(b)(6) motion to dismiss a complaint for failure to state a claim does not permit the drawing of adverse inferences. By filing such a motion, defendants convey to the court the message that: even if it accepts all well-pled facts as true, and draws all reasonable inferences "in the light most favorable to the plaintiff," as a matter of law, plaintiffs are not entitled to relief. *See* Wright & Miller, *Fed. Prac. & Proc. Civil 3d*, Vol. 5B, §1357 at 417. There is no room in that process for weighing against plaintiff potential conflicting inferences or explanations asserted by defendants. The court considers plaintiff's best case—not defendant's most plausible defense. Such weighing of disputed inferences is for the jury.

Since the adoption of Rule 12 in 1937, all federal courts have uniformly adhered to the rule that on a motion to dismiss, all facts and reasonable inferences are construed in plaintiff's favor. In *Conley v. Gibson*, 355 U.S. 41 (1957), this Court reaffirmed that "a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Id.* at 45-46. In passing on a motion to dismiss for failure to state a claim, "the allegations of the complaint should be construed favorably to the pleader." *Scheuer*, 416 U.S. at 236.

These principles can be traced back nearly 200 years. In 1808, Chief Justice Marshall stated: "***The party demurring admits*** the truth of the testimony to which he demurs and also ***those conclusions of fact which a jury may fairly draw*** from that testimony. Forced and violent inferences he does not admit; but the testimony is to be taken most strongly against him, ***and such conclusions as a jury might justifiably draw***

the court ought to draw." *Pawling*, 8 U.S. [4 Cranch] at 221-22 (emphasis added).

This Court has acknowledged the importance of inference-drawing in a securities fraud action: "proof of scienter required in fraud cases is often a matter of inference from circumstantial evidence." *Huddleston*, 459 U.S. at 387-90 & n.30 (holding that plaintiff must prove fraud only by a preponderance of the evidence). "'Circumstantial evidence is not only sufficient but may also be more certain, satisfying and persuasive than direct evidence.'" *Desert Palace, Inc. v. Costa*, 539 U.S. 90, 100 (2003) (citation omitted).

To guard against pleading abuses, however, this Court made it clear that courts "are not bound to accept as true a legal conclusion couched as a factual allegation." *Papasan v. Allain*, 478 U.S. 265, 286 (1986). The Securities Industry group, the only *amici* to even mention Rule 12(b)(6), assert that "courts need not accept the truthfulness of allegations that are merely conclusions, characterizations, or inferences." (Sec. Ind. Br. 20 & n.3) But their assertion omits the crucial word "***unwarranted***" from all of the cases they cite. The omission is significant. All courts hold that judges must accept reasonable inferences warranted by well-pled facts. Indeed, as this Court made clear, "What Rule 12(b)(6) does not countenance are dismissals based on a judge's disbelief of a complaint's factual allegations." *Neitzke v. Williams*, 490 U.S. 319, 327 (1989). Well-pled factual allegations must be accepted "as true" and construed in plaintiff's favor. *Leatherman v. Tarrant County*, 507 U.S. 163, 164 (1993); *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 508 n.1 (2002).

Petitioners and the SEC incorrectly treat Fed. R. Civ. P. 8 as the source of the inference-drawing rule, but in doing so fail to cite Rule 12(b)(6). (Pet. Br. 15, 21; SEC Br. 11-12) They cite *Conley* only for this Court's holding that under Rule 8 a plaintiff is not required to "detail the facts upon which he bases a claim" (355 U.S. at 47), but they ignore the separate holding of *Conley* that the adequacy of the complaint

on a Rule 12(b)(6) motion is judged by the ***best*** case plaintiff can plead. *Id.* at 45-46.

A. The PSLRA Does Not Address the Rule 12(b)(6) Practice that Inferences Are Drawn in Plaintiff's Favor, Which Under *Jones v. Bock* Can Only Be Changed by Amending the Rules

Petitioners' assertion that courts may consider inferences adverse to plaintiffs is not justified by any language in the PSLRA. The statute simply provides that in pleading fraud, plaintiff's "complaint" must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. §78u-4(b)(2). But as *Liberty Lobby* explained, a higher "strong inference" standard does not alter the civil rules. This Court assumes that Congress is "aware of existing law when it passes legislation." *Miles v. Apex Marine Corp.*, 498 U.S. 19, 32 (1990). Because the PSLRA says nothing about amending Rule 12(b)(6), it did not disturb bedrock jurisprudence requiring that reasonable inferences arising from complaint allegations be drawn in plaintiff's favor, and does not empower courts to draw inferences adverse to plaintiffs.

The plain language of the statute provides that "the complaint shall . . . state with particularity facts giving rise to a strong inference" of scienter. The statute and its legislative history says nothing about drawing or weighing adverse inferences. 15 U.S.C. §78u-4(b). Further, the Senate Committee stated that in adopting the "strong inference" standard: "The Committee does not adopt a new and untested pleading standard that would generate additional litigation." S. Rep. No. 104-98, at 15 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 694. "The PSLRA did not . . . purport to move up the trial to the pleadings stage." *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1101 (10th Cir. 2003). To accept the petitioners' theory would supplant the function of a trial.

Prior to the PSLRA, the "strong inference" standard had long been in use in the Second Circuit. *Shields v. Citytrust Bankcorp.*, 25 F.3d 1124, 1128 (2d Cir. 1994). That circuit, both before and since the PSLRA, adhered to the jurisprudential premise of Rule 12(b)(6) that "all reasonable inferences [are drawn] in plaintiff's favor" to assess whether the best case that he can plead meets the strong inference standard. *Rombach v. Chang*, 355 F.3d 164, 169 (2d Cir. 2004).

In January 2007, this Court unanimously held that "courts should generally not depart from the usual practice under the Federal Rules," except "by the process of amending the Federal Rules, and not by judicial interpretation." *Jones*, 127 S. Ct. 910 at *25; quoting *Leatherman*, 507 U.S. at 168; *accord Swierkiewicz*, 534 U.S. at 515; *Hill v. McDonough*, 547 U.S. __, 126 S. Ct. 2096, 2103 (2006). Although, unlike the statute in *Jones*, the PSLRA does require plaintiff to plead a "strong inference" with particularity, the PSLRA nowhere provides that courts can consider and weigh adverse inferences or competing explanations in determining a Rule 12(b)(6) motion. Under *Jones*, imposing such a "different and more onerous" inference-drawing regime "to deal with particular categories of cases should be done through established rule making procedures, and not on a case-by-case basis by the courts." *Jones*, 127 S. Ct. at *45-*46.

Petitioners and their *amici*, including the SEC, dwell on alleged pleading abuses as if they still exist. They totally ignore that as a result of the enactment of the PSLRA, securities class actions are better led and better pled due to the increasing role of large public pension fund fiduciaries—including *amici* on this brief—acting as institutional "lead plaintiffs." Such institutional plaintiffs provide responsible vigorous supervision of the litigation, precisely as Congress intended in enacting the lead plaintiff provision of the PSLRA. 15 U.S.C. §78u-4(a)(3)(B)(iii)(I)(bb). By creating a presumption that the "most adequate" candidate for lead plaintiff is the person or group that "has the largest financial

interest in the relief sought by the class," Congress intended to attract institutional investors to that role and specifically said as much in the legislative history. "The Conference Committee believes that increasing the role of institutional investors—[including public "pension funds" representing "small investors"]—in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions." H.R. Conf. Rep. 104-369 (1995), at *34, *reprinted in* 1995 U.S.C.C.A.N. 730, 733; *see In re Cendant Corp. Lit.*, 264 F.3d 201, 261, 264 (3d Cir. 2001); *accord In re Cavanaugh*, 306 F.3d 726, 738 (9th Cir. 2002).

Thus, it is both obsolete and wrong for petitioners, their industry *amici*, and also the SEC, to seek further judicially-created restrictions on private securities actions. Pension funds like *amici* here are experienced fiduciaries, governed by respected boards and advised by independent fund counsel, not simply by securities litigation counsel. They are not "lawyer-driven" or "professional plaintiffs" filing sham suits. Today, "shareholder class actions are fewer in number," but "better led" by pension funds and other institutional investors. The Economist, *Classier actions* (Feb. 15, 2007). There is empirical support for this. *See* James D. Cox & Randall S. Thomas, "Does the Plaintiff Matter?" 106 *Colum. L. Rev. 1587*, 1631 (2006). Institutional lead plaintiffs increase recoveries by statistically significant amounts.

In addition to the role of institutional plaintiffs, the PSLRA contains ample procedural safeguards to prevent sham conclusory pleading and the statute has been successful in doing so. The statute's "***strong inference***" and "***particularity***" requirements provide the principal protections. 15 U.S.C. §78u-4(b)(2). Further protection is provided by the PSLRA requirement that plaintiff plead a specific ***factual basis*** for allegations made on information and belief from witness and document sources. 15 U.S.C. §78u-4(b)(1); *Cabletron*, 311 F.3d at 28-33 (1st Cir. 2002); *Novak v. Kasaks*, 216 F.3d

300, 314 (2d Cir. 2000). Another is the court's ability to reject inferences in plaintiff's favor when they are unreasonable or unwarranted by the facts alleged. *Papasan*, 478 U.S. at 286. In light of these protections, the long-established analysis under Rule 12(b)(6) that focuses on the sufficiency of allegations and inferences construed in plaintiff's favor, viewed collectively, without competing explanations, does not thwart Congress' basic purpose in the PSLRA. Congress wanted to limit abusive, vague suits—not careful, measured actions of substance.

B. Under *Liberty Lobby*, The PSLRA "Strong Inference" Test for Pleading Scienter Does Not Change the Premise of Rule 12(b)(6) that Plaintiff Is Entitled to All Reasonable Inferences

This Court has held that in ruling on a dispositive motion as to a claim with an elevated standard of proof, though the court must view the facts "through the prism of the substantive evidentiary burden," still "[t]he evidence of the nonmovant is to be believed, and all justifiable inferences are to be drawn in his favor." *Liberty Lobby*, 477 U.S. at 254-56. This Court explained that its "holding that the clear-and-convincing standard of proof should be taken into account in ruling on summary judgment motions does not denigrate the role of the jury." *Id.* at 255. The Court reaffirmed that "the weighing of the evidence, and the draw-ing of legitimate inferences from the facts are jury functions." *Id.*

Although *Liberty Lobby* arose on summary judgment, the same reasoning applies with even greater force on a Rule 12(b)(6) motion because at that pretrial stage the court is precluded from even considering evidence—let alone resolving evidentiary disputes. The whole point of Rule 12(b)(6) is to assess plaintiff's ***best*** case—without competing explanations or possible adverse inferences—to determine whether "relief could be granted under any set of facts that could be

proved consistent with the allegations." *Hishon v. King & Spaulding*, 467 U.S. 69, 73 (1984).

Petitioners and the SEC totally overlook *Liberty Lobby*. They incorrectly assert that the Seventh Circuit erred in applying a "could infer" approach that somehow "diluted" the strong inference standard to mean only a reasonable inference. (SEC Br. 23) The SEC confuses "the relative strength of the inference required" with "the nature of the person drawing [it]." (*Id.* 23 n.7) Whether a rational juror "could infer" a strong inference of scienter from the totality of facts and inferences pled, viewed in plaintiff's favor, is precisely what *Liberty Lobby* and Rule 12(b)(6) require. As framed by this Court, when addressing a dispositive motion, "[t]he judge's inquiry, therefore, ***unavoidably asks*** whether reasonable jurors ***could find*** by a preponderance of the evidence"—here the facts alleged—"that the plaintiff is entitled to a verdict." *Liberty Lobby*, 477 U.S. at 252 (emphasis added).

In *Reeves*, 530 U.S. at 150, this Court applied *Liberty Lobby* in the context of a motion for judgment as a matter of law. This Court held that though a court reviews all of the evidence presented at trial, it "must draw all reasonable inferences in favor of the nonmoving party" and "***must disregard all evidence favorable to the moving party that the jury is not required to believe***." *Reeves*, at 150-51 (emphasis added). *Reeves* further held that the court impermissibly substitutes its judgment for that of the jury when it fails "to draw all inferences in favor of [nonmovant]." *Id.* at 152. These principles plainly apply on a Rule 12(b)(6) motion. When a court is "[f]aced with two seemingly equally strong inferences" at the pleading stage, one favoring plaintiff and one not, resolution is for the fact finder. *Pirraglia*, 339 F.3d at 1188. "The strong-inference pleading standard does not license us to resolve disputed facts at this stage of the case." *Green Tree*, 270 F.3d at 666. The PSLRA did not enact trial by complaint. *Adams*, 340 F.3d at 1101.

Thus, the Seventh Circuit's "could infer" approach is consistent with *Liberty Lobby*, *Reeves*, Rule 12(b)(6), and the PSLRA. It does not dilute the strong inference standard—it correctly applied it. Nowhere in its opinion does the Seventh Circuit equate a strong inference to one that is merely reasonable. The court simply concluded that reasonable inferences considered collectively, must add up to a strong inference. "'We []understand a "strong inference" of scienter to be a conclusion logically based upon particular facts that would convince a reasonable person that the defendant knew a statement was false or misleading.'" (App. 21a).

C. A "Strong Inference" Is Defined by the Second Circuit to Mean Sufficient Facts Pleaded from Which a Jury Could Find "More-Likely-Than-Not" that Defendant Acted with Scienter

Petitioners define a "strong inference as one that is "compelling," and "meaningfully tends to exclude the possibility of innocence" and leaves "little room for doubt." (Pet. Br. 25, 34 n.15) The SEC suggests a "high likelihood" standard. (SEC Br. 20-21) Such definitions would import a clear-and-convincing evidence or even a beyond-a-reasonable-doubt hurdle as hinted at by petitioners' "exclude . . . innocence" and "little room for doubt" rubrics (Pet. Br. 34), that are wrong under *Huddleston*. There, this Court rejected a clear-and-convincing test in securities cases and set a "preponderance-of-the-evidence" standard that is untouched by the PSLRA. *Huddleston*, 459 U.S. at 390. Nothing in the PSLRA suggests that Congress intended to impose a pleading standard that is so dramatically more demanding than the burden of proof at trial. In *Liberty Lobby*, this Court held that the standard at trial should also apply to a dispositive motion. 477 U.S. at 254-55.

The petitioners and the SEC never mention that the Second Circuit not only coined the term "strong inference," but also defined it. A strong inference of scienter is alleged when

"sufficient facts were pleaded to suggest that plaintiffs may be able to prove that defendants ***more likely than not*** knew their financial representations were false." *Cohen*, 25 F.3d at 1174 (emphasis added). This definition, articulated in the year before enactment of the PSLRA, was presumably known to Congress when it adopted the strong inference standard. *Miles*, 498 U.S. at 32.

The Second Circuit definition is consistent with the preponderance of evidence standard of *Huddleston*, and with this Court's explanation in *Liberty Lobby* that in ruling on a dispositive motion "through the prism" of any heightened standard, the judge "unavoidably asks whether reasonable jurors could find ***by a preponderance of the evidence***" that plaintiff is entitled to a verdict—here on the issue of scienter. *Liberty Lobby*, 477 U.S. at 252, 254 (emphasis added).

Further, the Second Circuit analysis required that only the ultimate inference of scienter—drawn from the facts alleged and inferences drawn viewed collectively—must be strong; the underlying component inferences need simply be reasonable ones. *Cosmas v. Hassett*, 886 F.2d 8, 11, 13 (2d Cir. 1989) (holding that underlying facts and reasonable inferences collectively gave rise to a strong inference, reading the complaint in plaintiff's favor). All circuits agree that the court must consider the ***totality*** of well-pled allegations and inferences drawn in plaintiff's favor. *See, e.g., Abrams v. Baker-Hughes, Inc.*, 292 F.3d 424, 430-31 (5th Cir. 2002) ("allegations should not be read in isolation, but taken together as a whole to see if they raise the necessary strong inference of scienter"); *City of Monroe Employees v. Bridgestone*, 399 F.3d 651, 683 (6th Cir. 2005) (the judges "employ a totality of circumstances analysis whereby the facts argued collectively must give rise to a strong inference."); *see Rockefeller*, 311 F.3d at 224-25 (allegations are not viewed as a totality unless they are stated with particularity).

This Court has itself emphasized the importance of viewing facts collectively and not in isolation. *Bourjaily v. United*

States, 483 U.S. 171, 179 (1987). As then Chief Justice Rehnquist explained, "individual pieces of evidence, insufficient in themselves to prove a point, may in cumulation prove it. The sum of an evidentiary presentation may well be greater than its constituent parts." *Id.* at 179-80.

In sum, evaluating motions to dismiss under the PSLRA is no different than any other Rule 12(b)(6) motion. Whether the complaint meets the "strong inference" standard can be determined consistently with Rule 12(b)(6) without doing violence to the Rule's premise that plaintiff is entitled to all justifiable inferences by analyzing the best case he can plead, as a totality, against the heightened standard.

II. Contrary to Petitioners' Tally, Only the Sixth and Ninth Circuits Weigh Inferences Adverse to Plaintiffs; All Other Circuits Correctly Give Plaintiffs the Benefit of All Reasonable Inferences—as with Every Other Element of Fraud

Contrary to petitioners' assertion that four or more circuits allow adverse inferences (Pet. 4), only two circuits, the Sixth and Ninth, have held that the PSLRA's "strong inference" standard allows district courts to consider and weigh adverse inferences in assessing scienter pleading. *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (*en banc*); *Gompper v. VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002). All other circuits adhere to Rule 12(b)(6) and afford plaintiff the benefit of all reasonable inferences. Indeed, for the elements of fraud other than scienter, all circuits agree that reasonable inferences from complaint allegations must be drawn in plaintiff's favor. *Helwig*, 251 F.3d at 553; *Gompper*, 298 F.3d at 895; *Pirraglia*, 339 F.3d at 1188.

With respect to scienter, the Sixth Circuit in *Helwig* held that, under the PSLRA, in determining whether plaintiff's complaint has sufficiently alleged a "strong inference" that defendants acted with scienter (intent, knowledge, recklessness), plaintiff's allegations "are entitled only to the ***most***

plausible of competing inferences." 251 F.3d at 553 (emphasis added). Petitioners' theory is even more extreme than the position of the Sixth Circuit. They boldly urge that plaintiff's complaint must "exclude the possibility of innocence." (Pet. Br. 17) The Sixth Circuit in *Helwig* rejected that approach: "Inferences must be reasonable and strong—but not irrefutable." 251 F.3d at 553; *accord Cabletron*, 311 F.3d at 38. "Plaintiffs need not foreclose all other characterizations of fact, as the task of weighing contrary accounts is reserved for the fact finder." *Helwig*, 251 F.3d at 553.

Moreover, in *Helwig* and in subsequent cases, the Sixth Circuit has been, to say the least, ambivalent. In *Helwig*, for example, the majority stated: "Contrary to defendants' contention, the Reform Act did not reverse the polarity of securities pleading." *Id.* The court added: "'When an allegation is capable of more than one inference, it must be construed in the plaintiff's favor.'" *Id.* (citation omitted). Indeed, the Court said: "Our willingness to draw inferences in favor of the plaintiff remains unchanged by the PSLRA." *Id.* In a later case, the court backtracked even further: "One might argue that for cases where a juror could conclude that the facts pleaded show scienter, but that conclusion would not be the most plausible of competing inferences, a Seventh Amendment problem is presented." *Bridgestone*, 399 F.3d at 683. The Seventh Circuit agreed. (App. 20a)

In *Gompper*, 298 F.3d at 896-97, the Ninth Circuit rejected plaintiff's argument that where the facts alleged give rise to reasonable inferences of scienter, the court must accept these inferences without considering competing plausible inferences suggested by defendants. *Id.* at 896-97. Believing there was an "inevitable tension" between Rule 12(b)(6) and the PSLRA, the court held that in determining whether plaintiff has sufficiently alleged a "strong inference" of scienter, "the court must consider ***all*** reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs." *Id.* at 897 (emphasis by the court).

In *Gompper*, the court reasoned that, if courts are required to consider only inferences favorable to plaintiffs when there are "equally or more plausible" adverse inferences, it would "eviscerate the PSLRA's strong inference requirement by allowing plaintiffs to plead in a vacuum," and "would allow all plaintiffs who engage in careful measured pleading to demonstrate a strong inference of scienter" that "would thwart Congress's basic purpose in raising the bar in the first place." *Id.* at 896-97. The Ninth Circuit's fears are misplaced. It overlooked the fact that to benefit from the inferences in the first place, or to have them considered collectively, the PSLRA requires that all of plaintiff's scienter allegations be stated with "particularity" and to have a specific "factual basis." 15 U.S.C. §78u-4(b). Thus, the particularity requirement ensures that plaintiffs do not plead in a vacuum. Moreover, contrary to the Ninth Circuit observation, "careful, measured pleading" is precisely what the PSLRA demands and courts should expect.

All other circuits that have engaged in the PSLRA strong inference analysis continue to give plaintiff the benefit of all reasonable inferences as contemplated by Rule 12(b)(6). The First Circuit explained that the PSLRA strong-inference standard does not change the rule that "a court must draw all reasonable inferences in plaintiff's favor" and then weigh them together to determine if "they satisfy" the strong inference standard. *In re Stone & Webster Sec. Lit.*, 414 F.3d 187, 195 (1st Cir. 2005); *accord Cabletron*, 311 F.3d at 28, 38 (Despite the PSLRA "strong inference" standard, the court "continues to give all reasonable inferences to plaintiffs" that, as a "totality" must be strong "but need not be irrefutable").

Contrary to petitioners' assertion (Br. 34-37), the First Circuit did not change its approach in *In re Credit Suisse First Boston Corp.*, 431 F.3d 36 (1st Cir. 2005). There, the court reaffirmed: "In considering a motion to dismiss, the district court is bound to 'assume the truth of all well-pleaded facts and ***indulge all reasonable inferences that fit the***

plaintiff's stated theory of liability.'" *Id.* at 45 (emphasis added). Although *Credit Suisse* observed that there were "legitimate explanations" that are "equally convincing" (*Id.* at 49), such weighing of conflicting explanations is contrary to the First Circuit's earlier holding that it is error to draw "inferences in the defendants' favor." *Aldridge*, 284 F.3d at 79. Because the earlier panel decision states circuit law, and can only be changed *en banc*, *Aldridge* is binding and cannot be overruled by the *Credit Suisse* panel. *See United States v. Malouf*, 466 F.3d 21, 26-27 (1st Cir. 2006).

The Eighth Circuit also expressly rejected *Helwig's* "competing inferences" theory. *In re K-Tel Intern, Inc. Sec. Litig.*, 300 F.3d 881, 889 n.6 (8th Cir. 2002). "The strong inference pleading standard does not license us to resolve disputed facts at this stage of the case." *Green Tree*, 270 F.3d at 666. The Second, Fifth and Eleventh Circuits likewise continue to draw inferences in plaintiff's favor. *Suez Equity Investors L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 100 (2d Cir. 2001); *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 424-25 (5th Cir. 2001); *Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1261 (11th Cir. 2006). The Third Circuit agrees, but explained that under the PSLRA the plaintiff gets the benefit of reasonable inferences provided the facts in the complaint are alleged with particularity. *Rockefeller*, 311 F.3d at 224.

Similarly, contrary to petitioners' description, the Tenth Circuit declined to draw adverse inferences, and instead took what it termed a "more contextual approach" stating:

> Whether an inference is a strong one cannot be decided in a vacuum. In evaluating the strength of a plaintiff's inference of scienter, we may recognize the possibility of negative inferences that may be drawn against the plaintiff. We do so, not in a preclusive manner, but in an evaluative manner. That is to say, we consider the inference suggested by the plaintiff while acknowledging other possible inferences, to determine whether

> plaintiff's suggested inference is "strong" in light of its overall context.

Pirraglia, 339 F.3d at 1187. Had the Tenth Circuit stopped there, its approach would be at odds with the Rule 12(b)(6) framework requiring consideration of plaintiff's best case. But the Court in *Pirraglia* proceeded to make clear that:

> [T]his process does not involve a 'weighing' of the plaintiff's suggested inferences against other inferences. Faced with two seemingly strong inferences, one favoring plaintiff and one favoring defendant, it is inappropriate for us to make a determination as to which inference will ultimately prevail, lest we invade the traditional role of the fact finder.

Id. at 1188. The Seventh Circuit agreed—correctly. (App. 21a)

Petitioners are also mistaken about the position of the Fourth Circuit, which continues to draw "reasonable inferences in [plaintiff's] favor." *In re PEC Solutions, Inc. Sec. Lit.*, 418 F.3d 379, 387 (4th Cir. 2005). That court takes a "flexible case-specific" approach to pleading with particularity facts giving rise to a strong inference. *Id.*; *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 383, 344-45 (5th Cir. 2003).

In sum, with the very limited exceptions of the Sixth and Ninth Circuits, all the others continue to recognize the essential premise of Rule 12(b)(6) and afford plaintiff the benefit of all reasonable inferences in assessing scienter under the PSLRA "strong inference" standard. Under *Liberty Lobby*, the majority view is correct.

III. Contrary to the SEC's Contentions, the PSLRA Does Not Require Courts to Consider Competing Inferences or Explanations; Doing So Would Violate the Right to Jury Trial

Eviscerating entirely the core premise of Rule 12(b)(6), the SEC asserts that in determining a "strong inference" under the PSLRA, courts "must" consider "other possible [non-culpable] explanations" or "any competing inference that can

be drawn." (SEC Br. 24) The SEC's position is wrong under *Liberty Lobby*—a decision the SEC simply ignores.

As discussed earlier, in *Liberty Lobby* this Court explained that in ruling on a dispositive motion, "the judge must view the evidence through the prism of the substantive evidentiary burden." *Liberty Lobby*, 477 U.S. at 254. The court emphasized, however, that the higher standard does not license the weighing of a competing story: "the weighing of evidence and the drawing of legitimate inferences from the facts are jury functions, not those of a judge . . . . The evidence of the nonmovant is to be believed, and all justifiable inferences are to be drawn in his [nonmovant's] favor." *Id.* at 255.

The SEC's theory is at odds with its view that the PSLRA made the then-existing Second Circuit strong inference test into a uniform national standard. (SEC Br. 8, 18) The SEC overlooks that the Second Circuit has been faithful to Rule 12(b)(6) by drawing all reasonable inferences in plaintiff's favor in determining whether a strong inference has been alleged—and did so both before and since the enactment of the PSLRA. *Shields*, 25 F.3d at 1128; *Rombach*, 355 F.3d at 169.

The SEC is also wrong in asserting that when reasonable inferences supporting scienter are matched by equally plausible non-culpable inferences, the ultimate inference of scienter is not strong because there is a "substantial possibility" that defendant acted without scienter. (SEC. Br. 25) When summary judgment evidence—or complaint allegation—and inferences drawn in nonmovant's favor—"may reasonably be resolved in favor of either party," the motion should be denied and the issue must be submitted to a fact finder for trial. *Liberty Lobby*, 477 U.S. at 250.

The SEC *amicus* brief represents a sharp shift in its position. The SEC has in numerous briefs previously stated that the PSLRA adopted the Second Circuit's strong inference test as a national rule. *See, e.g.*, SEC Br. in *Novak v. Kasaks*, No.

98-9641 (2d Cir. 1998) at 1-2. *Novak* is one of the SEC briefs filed between 1997 and 2001, in which the SEC consistently stated that the PSLRA adopted the Second Circuit pleading standard. *See also* SEC Br. in *Nathenson v. Zonagen*, No. 99-20449 (5th Cir. 1999) at 10-15. That standard was considered "the most stringent in the nation." *Novak*, 216 F.3d at 310-11. But even under that standard, both before and since the PSLRA, the Second Circuit draws all reasonable inferences in plaintiffs' favor. *Cohen*, 25 F.3d at 1174; *Rombach*, 355 F.3d at 169.

The SEC now seeks to distort the usual inference-drawing practice under Rule 12(b)(6) by calling for a judicial amendment rather than formal rulemaking, urging that courts "must consider competing inferences and non-culpable explanations for the defendant's conduct"—at the pleading stage. (SEC Br. 8-9, 20-21, 24-26) First, the SEC's approach is contrary to *Jones v. Bock*, which held Federal Rules practice can only be changed by amending the rules. 127 S.Ct. 910 at *25. Second, when the SEC changes position, this Court has not accorded it deference. *Int'l Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 566 n.20 (1979) (collecting cases); *see also American Federation v. American Intern.*, 462 F.3d 121, 129 (2d Cir. 2006). This Court should not defer to the SEC here because to do so would be contrary to the SEC's long-standing position—to which it now only pays lip-service—that "meritorious private actions are an essential supplement" to government enforcement, presumably for the protection of investors. (SEC Br. 1) But, "[s]etting the pleading threshold too high" by accepting the SEC position would "bar meritorious claims," and make it virtually impossible to plead securities fraud and violate Rule 12(b)(6).

A. The Strong Inference Standard Does Not License Trial by Complaint

Petitioners go even further and contend the Court "should consider and weigh" not only the allegations of the complaint,

but also "facts that support an inference of innocence" including "other facts properly before [it]." (Pet. Br. 17)

A motion to dismiss is not the stage of proceedings to consider evidence, let alone asserted facts outside the complaint. When evidence outside the complaint is offered, the motion to dismiss must be converted into one for summary judgment. Fed. R. Civ. P. 12(b). Although judicial notice of "undisputed facts" is permitted in connection with a Rule 12(b)(6) motion, courts cannot accept the truth of "disputed facts." *Lee v. City of Los Angeles*, 250 F.3d 668, 688-90 (9th Cir. 2001). Even for documents filed with the SEC, judicial notice is limited to determining what "the . . . documents contain, not to prove the truth of the documents contents." *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1275-77 (11th Cir. 1999). Congress recognized that filing a document with the SEC does not mean it is "true" and, indeed, may be "false or misleading." 15 U.S.C. §78z.

Petitioners cite *Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp.*, 475 U.S. 574, 587-88 (1986), where they say that this Court in an antitrust price-fixing case held that courts may consider and weigh competing inferences from evidence submitted on summary judgment. (Pet. Br. 30-31) *Matsushita* is not pertinent here. That decision addresses a unique concern in price-fixing cases that lawful conduct that encourages competition could be misconstrued as collusive, because "cutting prices to increase business often is the very essence of competition" which "antitrust laws are designed to protect." *Matsushita* at 593-94. There is no comparable concern here. Securities laws are designed to protect investors from deceptive conduct, and there is little or no danger that accounting manipulation, false financial projections, or active concealment of a company's financial problems would be misconstrued as legitimate conduct.

This Court has subsequently explained that *Matsushita* is limited to cases where the evidence consists only of *prima facie* legitimate and pro-competitive conduct, and, "in that

context," the inference of antitrust conspiracy was "speculative" and not "reasonable." *Eastman Kodak Co. v. Image Technical Services, Inc.*, 504 U.S. 451, 468 (1992). This Court reiterated in *Eastman Kodak*, citing *Liberty Lobby*, that "all justifiable inferences are to be drawn in [plaintiff's] favor." *Id.* at 456. Doubtless recognizing that *Matsushita* is inapposite here, the SEC never mentions it.

Petitioners also contend that the absence of allegations can be considered, particularly the absence of "economic motive" to commit fraud. (Pet. Br. 17) In fact, the absence of certain categories of allegations is "not decisive." *Cabletron*, 311 F.3d at 32. "Sufficient evidence of one type might reduce or eliminate the need for evidence in other categories, without thwarting the legislative intent behind the PSLRA." *Id.*; *see also Illinois v. Gates*, 462 U.S. 213, 238 (1983) (holding a deficiency in one element of probable cause can be offset by a strong showing as to the other element). The absence of motive cannot trump pleading of a strong inference based, for example, on defendants' admissions of fraud, or on witness and document sources.

When the inferences of culpability, viewed collectively, allow rational jurors to find a strong inference, even though there are seemingly plausible inferences to the contrary, Rule 12(b)(6) requires that a motion to dismiss be denied, and deferred to a jury for resolution.

B. Applying *Liberty Lobby* by Drawing All Reasonable Inferences in Plaintiffs' Favor Avoids Intrusion on the Right to Jury Trial

The SEC misconceives the issue when it asserts that the "strong inference" standard does not raise Seventh Amendment concerns. (SEC Br. 26-29) The constitutional issue is not presented by the Congressional standard, but by the government's assertion that judges deciding a Rule 12(b)(6) motion "must consider any competing inferences and nonculpable explanations." (SEC Br. 24) As discussed above,

under Rule 12(b)(6), the judge does not consider defendant's explanations or inferences—the jury does. If the totality of facts alleged and reasonable inferences drawn support a strong inference of conscious fraud, plaintiff is entitled to a jury trial. *Liberty Lobby*, 477 U.S. at 255.

The cases cited by the SEC hold that the right to a jury trial presents no obstacle to directed verdict or summary judgment because a determination had been made that the nonmovant did not have a triable case as a matter of law—but only after viewing the evidence in the nonmovant's favor. "'No one is entitled in a civil case to trial by jury unless and except so far as there are issues of fact to be determined.'" *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 336 (1979); citing *Ex Parte Peterson*, 253 U.S. 300, 310 (1920). But summary judgment will not lie if the dispute about a material fact is "genuine," that is when "the evidence is such that a reasonable jury could return a verdict for the nonmoving party." *Liberty Lobby*, 477 U.S. at 248. The "judge's function is not himself to weigh" the evidence or inferences, but only to determine whether they "***may reasonably be resolved in favor of either party***." *Id.* at 249-50 (emphasis added).

As noted above, these principles were drawn from the common law demurrer, as succinctly explained by Chief Justice Marshall in 1808: "The party demurring admits the truth of the testimony to which he demurs . . . and such conclusions [inferences of fact] as a jury might justifiably draw [in plaintiff's favor] the court ought to draw." *Pawling*, 8 U.S. [4 Cranch] at 221-22. Thus, allowing a judge charged with deciding a dispositive motion, as a matter of law, to become a fact finder who can weigh competing inferences and explanations would invade the right to a jury trial.

In sum, drawing inferences in plaintiffs' favor on a dispositive motion is not simply one of the "procedural incidents" of jury trial (*e.g.*, a court's exclusion of "evidence for irrelevancy"), but one of "its most fundamental elements" because such inference-drawing is dispositive of whether there

are issues of fact for a jury. *Galloway v. United States*, 319 U.S. 372, 389-90, 392, (1943). When a court ruling on a dispositive motion weighs competing inferences and "fails to draw all reasonable inferences in favor of [plaintiff]," it acts as a fact finder and "impermissibly substitute[s] its judgment concerning the weight of the evidence for the jury's." *Reeves*, 530 U.S. at 153. The Seventh Amendment ensures "that the ultimate determination of issues of fact by the jury be not interfered with." *Peterson*, 253 U.S. at 310. Applying *Liberty Lobby* and *Reeves* here—by drawing inferences in plaintiffs' favor—avoids any Seventh Amendment issue.

IV. This Court Should Reaffirm the Majority Rule that Plaintiff Is Entitled to All Reasonable Inferences Tested as a Totality Against the "Strong Inference" Standard; Allowing Inferences Adverse to Plaintiff Violates Rule 12(b)(6), and Would Seriously Impair Investor Recovery for Corporate Fraud

Setting aside the hyperbole of petitioners and their *amici* who dwell on abuses reported in some securities actions prior to the 1995 enactment of the PSLRA, this case arises against a very different factual landscape. For the past five years—the Enron era—our markets have suffered an unprecedented number of corporate accounting scandals causing $7 trillion in losses to investors and retirees. Millions of Americans have watched their entire retirement income disappear. But securities fraud is not confined to huge scandals like Enron. There are many small and medium size frauds that have caused investors, including public pension funds whose middle class members can ill afford the loss of their entire retirement savings, to suffer substantial injury. When corporate insiders manipulate the market, often with the complicity of banks, accountants and lawyers, courts should be cautious not to raise the bar of the PSLRA any higher than its already heightened standards—requiring particularity, a factual basis and a strong inference. 15 U.S.C. §78u-4(b).

Petitioners' adverse inference theory endorses trial on the complaint—without evidence. That approach would produce needless confusion and inconsistency. Congress did not contemplate such a far-reaching change in long-standing pleading practice. "The PSLRA did not . . . purport to move up the trial to the pleading stage." *Adams*, 340 F.3d at 1101.

Petitioners' approach sends the wrong message at the wrong time. "Unless reasonable inferences from circumstances suffice to get a case to a jury, the welfare of victimized investors and the integrity of the stock market may be insufficiently protected from deceptive manipulations." *Ronconi*, 253 F.3d at 428. The PSLRA "was not enacted to raise the pleading burdens" to a level that "facially valid claims" must be "routinely dismissed on Rule 9(b) and 12(b)(6) motions." *ABC Arbitrage*, 291 F.3d at 354; *accord Cabletron*, 311 F.3d at 30.

The Grundfest *amici* seek to narrow the scope of the private cause of action in securities fraud even beyond the limits imposed by Congress in the PSLRA. (Grundfest Br. 4) In the process, they ignore and appear willing to undermine longstanding Rule 12(b)(6) jurisprudence. They also ignore entirely the teaching of *Liberty Lobby* that, despite a heightened standard, in ruling on a dispositive motion, "all justifiable inferences are to be drawn in [plaintiff's] favor." 477 U.S. at 255. Contrary to Grundfest's assertion (Br. 4), weighing and comparison of possible competing inferences from the facts "are jury functions, ***not those of a judge***." *Id.* (emphasis added). Grundfest never mentions *Liberty Lobby*, worse yet, there is no mention of Rule 12(b)(6). Grundfest, like other *amici*, discuss *ad nauseum* asserted pleading abuses that led to the PSLRA. (*Id.* at 12-16) They simply refuse to face the reality that securities actions today are fewer and better—and both better led and better pled by institutional investors like the *amici* on this brief.

This Court's decision in *Huddleston* further contradicts *amici's* theories. The Court reversed a Court of Appeals

ruling that plaintiffs must prove a §10(b) claim by clear and convincing evidence, and held that a preponderance of the evidence suffices. 459 U.S. at 387-91. The Court reasoned that "[a]ny other standard expresses a preference for one side's interests." *Id.* at 390. The Court recognized that "the interests of plaintiffs in such suits are significant. Defrauded investors are among the very individuals Congress sought to protect in the securities laws." *Id.* This Court emphasized that the "existence of [a private §10(b) action] is simply beyond peradventure." *Id.* at 380. Indeed, Congress codified such actions in the PSLRA. 15 U.S.C. §78u-4(a)(1).

Congress adopted the strong inference standard to deter pleading abuses, not to do away with private suits entirely—which a rule allowing the weighing of competing inferences could bring about. In enacting the PSLRA, Congress made clear that: "Private securities litigation is an ***indispensable tool*** with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs." H.R. Conf. Rep. 104-369 at *31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730.

In sum, this Court should reaffirm the majority rule that, despite the heightened standard in the PSLRA, Rule 12(b)(6) still requires that the court consider whether plaintiff's best case, drawing all inferences in plaintiff's favor and considered as a "totality," raises a "strong inference" of scienter.

CONCLUSION

The Court should affirm the holding of the Seventh Circuit that on a motion to dismiss, plaintiff is entitled to all reasonable inferences from well-pled facts.

Respectfully submitted,

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TELLABS, INCORPORATED AND RICHARD C. NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF FOR THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AND THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF THE *AMICI CURIAE*

The Securities Industry and Financial Markets Association (SIFMA) is a trade association that results from the November 1, 2006 merger of the Securities Industry Association and The Bond Market Association. It brings together the shared interests of more than 650 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that expand and improve markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests in the United States and globally. It has offices in New York, Washington, D.C., and London.

The Chamber of Commerce of the United States of America ("Chamber") is the world's largest business federation. The Chamber's underlying membership includes more than three million companies and professional organizations of every size, in every industry sector, and from every region of the country. An important function of the Chamber is to represent the interests of its members in matters before Congress, the Executive Branch, and the courts. To that end, the Chamber regularly files *amicus curiae* briefs in cases that raise issues of concern to the nation's business community.[1]

The question presented here—the proper test for determining the sufficiency of scienter allegations in securities fraud cases—is an issue of recurring importance to public companies, to the financial services industry, and to investors. *Amici* have a vital interest in ensuring that the standards of the Private Securities Litigation Reform Act ("PSLRA"), which Congress passed to curb vexatious litigation, are not

[1] Pursuant to Rule 37.6, *amici* affirm that no counsel for a party authored this brief in whole or in part and that no person other than *amici* and their counsel made a monetary contribution to its preparation or submission. The parties' consents to the filing of this brief are on file with the Clerk's office.

weakened and are properly applied. Rather than repeat petitioners' legal arguments, this brief describes the substantial practical harm that would result to issuers, investors, and the Nation's financial markets from the Seventh Circuit's lax approach to pleading scienter.

SUMMARY OF ARGUMENT

To avoid dismissal, the PSLRA requires plaintiffs bringing claims for securities fraud to plead "with particularity" facts that give rise to a "strong inference" of scienter. 15 U.S.C. § 78u-4(b)(2). The Seventh Circuit held that plaintiffs satisfied that heightened pleading requirement by alleging facts from which a reasonable person "could infer" scienter. Pet. App. 20a. The Court should reject the Seventh Circuit's overly permissive "could infer" test and instead hold that plaintiffs alleging claims for securities fraud must plead facts that strongly tend to exclude innocent explanations for the challenged conduct.

As we explain below, the Seventh Circuit's "could infer" test moves in the opposite direction from that chosen by Congress, easing plaintiffs' pleading burden and encouraging the abusive strike suits that the PSLRA set out to prevent. The Seventh Circuit's test allows Section 10(b) suits based on speculative scienter allegations to evade early dismissal. It thereby enables plaintiffs wielding abusive discovery demands and the threat of massive class action jury awards to coerce defendants into settling meritless claims. The costs of these "blackmail settlements" limit the resources corporations have available to hire additional employees and develop useful products, while making it more difficult for them to attract high-quality professionals to sit on corporate boards and provide auditing and other services essential to capital formation. Abusive securities fraud litigation is also driving foreign companies away from the United States' public markets, with two recent bipartisan reports warning that the United States risks losing its position as the leader in the global financial marketplace unless the threat of runaway class action liabili-

ties is contained. And companies are reluctant to disclose information about their future prospects to investors for fear of being exposed to a strike suit should their predictions turn out to be overly optimistic.

The high costs imposed by abusive securities fraud litigation far outweigh any benefits that a broad scienter rule might provide. Diversified shareholders generally break even from investments in securities impacted by delayed release of information even before considering recoveries from litigation, which provide only minimal compensation while extracting wasteful transaction costs. There are a host of judicial and administrative remedies available to investors that more efficiently vindicate the policies underlying the securities laws. There is no reason, accordingly, for this Court to allow Section 10(b) suits based on conclusory allegations of scienter to escape early dismissal.

ARGUMENT

I. THE BACKGROUND OF THE PSLRA'S ENACTMENT DEMONSTRATES THE NEED FOR A RIGOROUS SCIENTER STANDARD.

The Seventh Circuit held that plaintiffs may escape dismissal of a Section 10(b) claim by pleading facts from which a reasonable person "could infer" scienter. Pet. App. 20a. But Congress enacted the PSLRA to create a "more stringent" scienter pleading standard that bars speculative strike suits and thereby prevents plaintiffs from wielding the threat of litigation costs and massive class action jury awards to coerce defendants into settling meritless claims. H.R. Conf. Rep. No. 104-369, at 41 (1995), reprinted in 1995 U.S.C.C.A.N. 730 ("H.R. Conf. Rep."). This Court should insist on a rigorous pleading standard that screens out conjectural claims of scienter.

1. To understand Congress's goals in enacting the PSLRA, we begin with a description of the problems that prompted that legislation. During an "'ebullient' stage" in the development of implied causes of action, this Court found an

implied cause of action under Section 10(b) even though there is no indication that Congress "considered the question of private civil remedies under this provision." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 729-730 (1975); LOSS & SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1025 (3d ed. 1995). To prevent this "judicial oak" grown from a "legislative acorn" from resulting in "'liability in an indeterminate amount for an indeterminate time to an indeterminate class,'" this Court has invoked various "policy considerations" in repeatedly rejecting "expansive imposition of civil liability" under Section 10(b). *Blue Chip Stamps*, 421 U.S. at 737, 739, 748.

The Court has recognized that Section 10(b) suits "presen[t] a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps*, 421 U.S. at 739; see *Merrill Lynch* v. *Dabit*, 126 S. Ct. 1503, 1510 (2006). It has observed that the risk of crippling jury awards means that "even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment." *Blue Chip Stamps*, 421 U.S. at 740. The threat of costly and disruptive discovery adds an additional "*in terrorem* increment" to the settlement value of even meritless claims. *Id.* at 741. And the benefits to shareholders of an expansive Section 10(b) claim—which "'will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers'"—are uncertain at best. *Id.* at 739.

Accordingly, this Court has limited the scope of Section 10(b) actions repeatedly to curtail their coercive potential and make meritless claims easier "'to dispose of before trial.'" *Blue Chip Stamps*, 421 U.S. at 742-743; see *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) (requiring proof of scienter, not mere negligence); *TSC Indus.* v. *Northway*, 426 U.S. 438 (1976) (rejecting lax definition of materiality); *Santa Fe In-*

dus. v. *Green*, 430 U.S. 462 (1977) (limiting Section 10(b) to manipulative or deceptive conduct); *Schreiber* v. *Burlington Northern*, 472 U.S. 1 (1985) (confining Section 14(e) to manipulative acts that involve misrepresentation or nondisclosure); *Central Bank* v. *First Interstate Bank*, 511 U.S. 164, 189 (1994) (rejecting aiding and abetting claims because they would engender "uncertainty and excessive litigation"); *Dura Pharmaceuticals* v. *Broudo*, 544 U.S. 336 (2005) (requiring that loss causation be pled).

2. Despite these judicially imposed limitations, "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and 'manipulation by class action lawyers of the clients whom they purportedly represent'" continued to "resul[t] in extortionate settlements, chilled any discussion of issuers' future prospects, and deterred qualified individuals from serving on boards of directors." *Dabit*, 126 S. Ct. at 1510-1511 (quoting H.R. Conf. Rep. at 31). Congress enacted the PSLRA in response to "significant evidence of abuse," which undermined "American capital markets" and caused "serious injuries to innocent parties" who were "forced to pay exorbitant 'settlements.'" H.R. Conf. Rep. at 31-32. In doing so, Congress sought "to protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation." *Ibid.*

The PSLRA's heightened pleading requirements—including the requirement that plaintiffs plead a "strong inference" of scienter—formed a key part of Congress's effort to curb abusive Section 10(b) suits. *Dabit*, 126 S. Ct. at 1511. The flood of Section 10(b) class actions filed since the stock market bubble burst in 2000—together with the "rise in settlement sizes to new and unprecedented levels"—confirms that the need for a rigorous scienter standard remains acute. Pet. 17; INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 75 (Dec. 5, 2006), available at http://tinyurl.com/yqdy8n ("INTERIM REPORT").

II. THE SEVENTH CIRCUIT'S "COULD INFER" TEST UNDERMINES CONGRESSIONAL INTENT AND WOULD DO MORE HARM THAN GOOD.

The Seventh Circuit's permissive scienter pleading rule "would bring about harm of the very sort the [PSLRA] seek[s] to avoid," *Dura*, 544 U.S. at 347, and "'will ultimately result in more harm than good.'" *Hochfelder*, 425 U.S. at 214 n.33. The Seventh Circuit's rule would cause a host of negative consequences for public companies, investors, and the financial markets while providing no countervailing enforcement benefits.

A. Allowing Cases With Speculative Scienter Allegations To Evade Dismissal Creates Coercive Pressure To Settle Even Meritless Section 10(b) Suits.

Once a Section 10(b) case survives dismissal, Congress understood, plaintiffs can use discovery "to impose costs so burdensome that it is often economical for the victimized party to settle." H.R. Conf. Rep. at 31; see also H.R. Conf. Rep. No. 105-803, at 13 (1998) (companies often settle strike suits "simply to avoid the potentially bankrupting expense of litigating"). Indeed, "fishing expedition" discovery accounts for 80% of the costs of defending Section 10(b) suits. H.R. Conf. Rep. at 37. Discovery also requires "key employees" to spend time responding to discovery requests and being deposed. *Ibid.* This Court has observed that discovery abuses may exist in Section 10(b) cases "to a greater extent than they do in other litigation": "extensive deposition of the defendant's officers and associates and the concomitant opportunity for extensive discovery of business documents is a common occurrence." *Blue Chip Stamps*, 421 U.S. at 741.

That discovery burden falls disproportionately on defendants, who "posses[s] the bulk of the relevant information." H.R. Rep. No. 104-50, at 16 (1995); see PERINO, SECURITIES LITIGATION AFTER THE REFORM ACT § 4.01A, at 4013 (2006) (Section 10(b) defendants face "asymmetrical discovery burdens"). Plaintiffs have little incentive to limit abusive discov-

ery demands because class members possess few documents that could be subject to burdensome requests. See Easterbrook, *Discovery as Abuse*, 69 B.U. L. REV. 635, 643, 645 (1989) ("Large litigants have files—warehouses of files. The adversary can demand that they be searched, at great cost; the adversary can notice the depositions of 20 corporate officers. What can the large litigant do to retaliate?"). And to the extent that the discovery process "permits a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence, it is a social cost rather than a benefit." *Blue Chip Stamps*, 421 U.S. at 741.

Beyond massive litigation costs, the Section 10(b) suits reflexively filed after every downward fluctuation in stock prices carry the risk of enormous jury awards to a large class of plaintiffs. "[B]asic economics" can force defendants to settle "meritless" class actions that have "only a five percent chance of success." S. Rep. No. 109-14, at 21 (2005), reprinted in 2005 U.S.C.C.A.N. 3; see also *Coopers & Lybrand* v. *Livesay*, 437 U.S. 463, 476 (1978); Fed. R. Civ. P. 23(f), 1998 Comm. Note. If a Section 10(b) suit survives dismissal and a class is certified, the risks of a jury trial are so enormous that defendants have little choice but to settle. See WILLGING ET AL., EMPIRICAL STUDY OF CLASS ACTIONS IN FOUR FEDERAL DISTRICT COURTS: FINAL REPORT TO THE ADVISORY COMMITTEE ON CIVIL RULES 184 table 40 (1996). However meritless the suit, corporate executives are "unwilling to bet their company that they are in the right." *Blair* v. *Equifax Check Servs.*, 181 F.3d 832, 834 (7th Cir. 1999). There is widespread agreement that this phenomenon of "blackmail settlements," "induced by a small probability of an immense judgment," poses a serious problem. *In re Rhone-Poulenc Rorer Inc.*, 51 F.3d 1293, 1298 (7th Cir. 1995) (quoting FRIENDLY, FEDERAL JURISDICTION: A GENERAL VIEW 120 (1973)).

The "hydraulic pressure on defendants to settle" (*Newton* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 164 (3d Cir. 2001)) is particularly acute in securities fraud class actions, which "have a much higher settlement rate than other types of class actions." S. Rep. No. 104-98, at 6 (1995), reprinted in 1995 U.S.C.C.A.N. 679. Settlement costs in securities fraud class actions are now at an all-time high, with seven of the ten largest settlements ever occurring during the past two years. Coffee, *Nobody Asked Me, But . . .*, N.Y.L.J., Jan. 18, 2007, at 5. Corporations paid $9.6 billion to settle securities fraud class actions in 2005 alone, up from $2.9 billion in 2004. Davies, *Moving the Market: Class-Action Pay Settlements Soar*, WALL ST. J., Feb. 7, 2006, at C3 (noting that the overall figure is the largest ever even after excluding the WorldCom and Enron settlements); see CORNERSTONE RESEARCH, POST-REFORM ACT SECURITIES SETTLEMENTS—2005 REVIEW & ANALYSIS (2006), available at http://tinyurl.com/ywhf7w. As former SEC Chairman Arthur Levitt observed, if the defendant "cannot win an early dismissal," simple economics "may dictate a settlement even if the defendant is relatively confident that it would prevail at trial." S. Rep. No. 104-98, at 7.

Empirical studies confirm that "the merits do not matter" in Section 10(b) class actions that proceed beyond the dismissal stage. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 501 (1991) (Section 10(b) became "a grotesquely inefficient form of insurance against large stock market losses" that "encourages the filing of more and weaker suits"). Bet-the-company damages claims and massive litigation costs coerce defendants into paying settlements that are neither "voluntary," because the risks make trial not "a practically available alternative," nor "accurate," because "the strength of the case on the merits has little or nothing to do with determining the amount of the settlement." *Id.* at 499; accord Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L. ECON. & ORG. 55 (1991).

Few securities cases settle before the trial court rules on a motion to dismiss. But the pressure to settle weak suits becomes irresistible once dismissal is denied, discovery begins, and a class is certified. The Seventh Circuit's lax standard for pleading scienter, by failing to screen out conjectural Section 10(b) claims at the earliest stages of litigation, enables plaintiffs to exert this "hydraulic pressure" on defendants to settle cases with little relationship to the merits. It runs directly counter to Congress's attempt in the PSLRA to make the merits relevant once again by eliminating insubstantial suits at the pleading stage, before they impose coercive consequences.

B. Abusive Securities Fraud Suits That Survive Dismissal Burden The Economy And Reduce The United States' Competitiveness In The Global Marketplace.

The costs of abusive litigation are "'an Achilles heel for our economy.'" Solomon, *Treasury's Paulson Warns of the Costs of Rules Overlap*, WALL ST. J., Nov. 21, 2006, at A2 (quoting Secretary of Treasury). A recent study of 500 securities fraud class actions filed after passage of the PSLRA concluded that they destroyed at least 3.5 percent of the equity value of the defendant, resulting in $25 billion in shareholder wealth being "wiped out just due to litigation." THAKOR, THE UNINTENDED CONSEQUENCES OF SECURITIES LITIGATION 14 (U.S. Chamber Institute for Legal Reform 2005), available at http://tinyurl.com/26d57f. Start-up companies—targeted by the plaintiffs' bar because of the volatility in their share price—"bear the brunt of abusive securities fraud lawsuits" and suffer a disproportionate loss of equity value from litigation. S. Rep. No. 104-98, at 9; see *Securities Litigation Reform Proposals: Hearings on S. 240, S. 667, and H.R. 1058 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 110 (1995) (half of Silicon Valley companies have been subjected to securities fraud class actions).

By reducing the equity value of defendants, abusive securities fraud litigation results in lower capital investment, which in turn "has obvious implications for job creation and economic growth." THAKOR, *supra*, at 14. "Instead of spending money on research and development or hiring more employees or reducing the cost of their products," Section 10(b) suits force companies to "spend that money on strike suit insurance and legal fees." H.R. Rep. No. 104-50, at 20.

Section 10(b) litigation also has enormously destructive ripple effects. A "fear of baseless and extortionate securities lawsuits" has made it "'extremely difficult to attract qualified, independent people to sit on corporate boards,'" which in turn has injured "the investing public and the entire U.S. economy." S. Rep. No. 104-98, at 21; H.R. Conf. Rep. at 31-32; see INTERIM REPORT at 11-12. Fear of strike suits extends to investment bankers, accountants, and other professionals whose services are essential to capital formation and efficient market operation, driving up the cost of their services and causing some to decline higher-risk engagements. S. Rep. No. 104-98, at 21-22; see also *id.* at 9 ("Underwriters, lawyers, accountants, and other professionals are prime targets of abusive securities lawsuits. The deeper the pocket, the greater the likelihood that a marginal party will be named as a defendant"). The difficulty of obtaining high-quality professional services falls disproportionately on "newer and smaller companies" because their "business failure would generate securities litigation against the professional." *Central Bank*, 511 U.S. at 189; H.R. Rep. No. 104-50, at 20.

There is also bipartisan consensus that the threat posed by securities fraud class actions deters foreign companies from entering the United States' public markets. The independent Committee on Capital Markets Regulation recently concluded that "the United States is losing its leading competitive position as compared to stock markets and financial centers abroad" in part due to the growth of "liability risks" that are absent overseas. INTERIM REPORT at ix-x. The United States' share of initial public offerings ("IPOs") issued by

foreign companies declined from 50 percent in 2000 to only 5 percent in 2005. *Id.* at 29. In 2005, 24 of the 25 largest IPOs worldwide were issued in markets outside the United States, with 9 of the 10 largest IPOs issued during the first 9 months of 2006 taking place in foreign markets. *Id.* at 30. Even domestic companies have begun fleeing the United States' markets. Twenty-three percent of IPO funds raised by domestic companies in 2005 were raised abroad. *Id.* at 32.

When foreign companies do raise money in the United States, they increasingly do so through the private equity market, which "has become foreign issuers' market of choice for U.S. equity issues." INTERIM REPORT at 46. In 2005, 90 percent of international equity issued in the United States (by volume) was completed in the private market, up from 50 percent in 1995. *Ibid.* Because "only institutions and wealthy individuals can participate directly in [the private equity] market," the average investor is left "in increasingly less liquid and more expensive markets than those enjoyed by institutions and the wealthy." *Id.* at 34. The "increasing preference" for private equity markets "is particularly telling given the lower cost of capital in the public markets," which "strongly suggests that the regulatory and litigation burden is an important factor in the choice between public and private markets." *Id.* at 46.

The Committee on Capital Markets Regulation concluded that the threat of litigation constitutes a principal reason for the decline in offerings by foreign companies in the United States' public markets. Securities fraud class actions are nonexistent in the United Kingdom and other major foreign markets. INTERIM REPORT at 71. By contrast, securities class action settlement costs in the United States stood at $9.6 billion in 2005. *Id.* at 46. Those liabilities result in insurance costs for Fortune 500 companies that are six times higher than in Europe. *Id.* at 78.

A recent report commissioned by Senator Charles Schumer and New York City Mayor Michael Bloomberg

similarly warned that foreign companies are "staying away from US capital markets for fear that the potential costs of litigation will more than outweigh any incremental benefits of cheaper capital." BLOOMBERG & SCHUMER, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP 101 (Dec. 2006), available at http://tinyurl.com/2fhyuf. The report recognized that "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of business—and driven away potential investors." *Id.* at ii. Moreover, "the legal environments in other nations, including Great Britain, far more effectively discourage frivolous litigation." *Ibid.* As a result, New York's "pre-eminence in the global financial-services sector" is losing ground to London and other international business centers. Schumer & Bloomberg, *To Save New York, Learn From London*, WALL ST. J., Nov. 1, 2006, at A18; see also Atkins, *A Serious Threat to Our Capital Markets*, WALL ST. J., June 10, 2006, at A12 (SEC Commissioner Atkins explains that "[l]itigation risks * * * lessen the international appetite for our capital markets").

Section 10(b) suits are also burdensome to the federal government because they "consume significant judicial resources" and are "subsidized by the U.S. taxpayer." Coffee, *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1540 (2006). Constituting almost half of all class actions pending in federal court in recent years, they are "the 800-pound gorilla that dominates and overshadows other forms of class actions." *Id.* at 1539-1540. In addition to "the sheer weight of their numbers, securities class actions disproportionately claim judicial time and attention" because "they take longer to resolve" and require the court "to play a more active monitoring role." *Ibid.*; see Alexander, *supra*, 43 STAN. L. REV. at 572 (describing the "cost to the public in judicial resources").

C. Lax Pleading Rules That Allow Meritless Claims To Evade Early Dismissal Create Disincentives To Full Disclosure To The Marketplace.

Allowing cases with speculative scienter allegations to evade dismissal undermines Congress's intent "to encourage the voluntary disclosure of information * * * about the financial condition of publicly traded companies." S. Rep. No. 104-98, at 5. Congress and the SEC understand that "[a]busive litigation severely affects the willingness of corporate managers to disclose information to the marketplace." H.R. Conf. Rep. at 42; see S. Rep. No. 104-98, at 9 ("Many companies refuse to talk or write about future business plans, knowing that projections that fail to materialize will inevitably result in a lawsuit"); SEC, Release No. 33-7107, 59 Fed. Reg. 52723, 52728 (1994) ("the threat of mass shareholder litigation * * * has had a chilling effect on disclosure of forward-looking information"). A firm that discloses information to the marketplace "takes the risk of excessive optimism and excessive pessimism." EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 339 (1991). Litigation "penalizing excesses in either direction" creates an incentive for management "to volunteer nothing" about the firm's prospects. *Ibid.*; H.R. Rep. No. 104-50, at 19.

Investors "want the issuer's own view of its future," which is "'the most valuable information shareholders and potential investors could have.'" KRIPKE, THE SEC AND CORPORATE DISCLOSURE 25 (1979); S. Rep. No. 104-98, at 15-16 (quoting former SEC Chairman Richard Breeden). But abusive securities litigation chills "the robustness and candor of disclosure." S. Rep. No. 104-98, at 15-16; see also H.R. Conf. Rep. at 31-32 ("the investing public and the entire U.S. economy have been injured by the unwillingness of * * * issuers to discuss publicly their future prospects, because of fear of baseless and extortionate securities lawsuits"). The risk of massive liability also muzzles companies' communications with analysts, which are "necessary to the preservation of a healthy market." *Dirks* v. *SEC*, 463 U.S. 646, 658-

659 (1983); see SEC, Release No. 33-7881, 65 Fed. Reg. 51716, 51718 n.19 (2000). When SEC disclosure requirements do not make silence an option, firms may respond with defensive disclosures that "bury the shareholders in an avalanche of trivial information." *TSC Indus.*, 426 U.S. at 448; see *Basic Inc.* v. *Levinson*, 485 U.S. 224, 231 (1988).

Permitting litigation based on speculative scienter theories to proceed past a motion to dismiss also burdens constitutionally protected speech in which there is a strong public interest. See *Lowe* v. *SEC*, 472 U.S. 181, 210 & n.58 (1985) (there is "no doubt about the protected character" of "the expression of an opinion about a marketable security," "factual information" about "market trends," and "commentary" on "market conditions"); *Nike, Inc.* v. *Kasky*, 539 U.S. 654, 664 (2003) (Stevens, J., concurring); *id.* at 676-678 (Breyer & O'Connor, JJ., dissenting). As the United States explained in *Nike*, the "First Amendment does not tolerate" an open-ended "private cause of action" for monetary relief against a company for "false statements respecting its products"—whether those statements "constitute 'commercial or noncommercial'" or hybrid speech—because such "unconstrained" actions pose "a serious threat of unjustifiable chill to legitimate speech on matters of public interest" and to "the free flow of information." 2003 WL 899100, at *7-8, *12, *20, *25.

A lax scienter pleading standard would detract from the quantity and quality of information provided to the marketplace. In adopting more stringent limits on private damages actions in the PSLRA, Congress sought to address that concern. H.R. Rep. No. 104-50, at 19. This Court has refused to interpret the Exchange Act in ways that undermine the free flow of information, and should do so once again here. *Dirks*, 463 U.S. at 658-659.

D. Section 10(b) Suits Enrich Plaintiffs' Lawyers But Provide Investors With Little Benefit.

Diversified investors are "fully compensated for [their] trading loses that are due to securities fraud by windfalls on

other transactions" and "have no need for further compensation obtained through litigation." Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1502 (1996); see Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 646 (1996) (diversified investors "have roughly the same chance of being winners as losers from securities fraud, and over time these gains and losses will tend to net out toward zero even in the absence of litigation"). This is because every delayed announcement of accurate firm information produces both winners (who sold during the period of inflation) and losers (who bought then and sold after disclosure of the truth). POSNER, ECONOMIC ANALYSIS OF THE LAW 489 (5th ed. 1998). "Over the long run, any reasonably diversified investor will be a buyer half the time and a seller half the time" and will not benefit from litigation forcing "his winning self to compensate his losing self over and over." EASTERBROOK & FISCHEL, *supra*, at 340.

A recent study confirms that diversified investors "generally break even from their investments in common stocks impacted by fraud allegations even prior to considering any recoveries through litigation." THAKOR ET AL., THE ECONOMIC REALITY OF SECURITIES CLASS ACTION LITIGATION 5-6 (U.S. Chamber Institute for Legal Reform 2005), available at http://tinyurl.com/ytyqtz. Punishing a company's shareholders with a Section 10(b) class action is therefore "like seeking to deter burglary by imposing penalties on the victim for having suffered a burglary." Coffee, *supra*, 106 COLUM. L. REV. at 1537.

Even "undiversified investors are seldom likely to receive a monetary benefit from the securities class action" because "the typical small, undiversified investor is likely to be a 'buy and hold' investor who does not trade frequently" and is thus "more likely to have purchased * * * stock before the class period commenced." Coffee, *supra*, 106 COLUM. L. REV. at 1559-1560. As a result, securities fraud class actions "transfer wealth systematically from 'buy and hold' investors

(who bought on average outside the class period) to more rapidly trading investors (who purchase on average within the class period)." *Id.* at 1560. "[T]he small investor who buys and holds for retirement" is thus "[t]he clearest loser" in securities class actions. *Ibid.* And "[t]he investors who are the most likely to be compensated through class action litigation—large institutional investors—are precisely those who are most diversified and thus are the least in need of compensation." Alexander, *supra*, 48 STAN. L. REV. at 1502. "From this perspective, recoveries from class action litigation represent a windfall to large investors." *Ibid.*; see THAKOR, ECONOMIC REALITY, *supra*, at 6 ("Large institutional investors are, in fact, often *overcompensated* as a result of litigation").

To make matters worse, shareholder plaintiffs "often receive only pennies on the dollar in damages" and incur significant transaction costs in the process. S. Rep. No. 104-98, at 9. The average securities class action settles for two to three percent of the investor's losses. Coffee, *supra*, 106 COLUM. L. REV. at 1545. These low percentages "are before the subtraction of the full costs that investors bear." *Id.* at 1546. Plaintiffs' attorneys received about one-third of the value of securities fraud settlements during the 1990s, with defense costs typically ranging from 25% to 35% of the settlement. *Ibid.* High defense costs "imply a higher insurance premium, as the insurer passes its costs back to the corporation and its shareholders." *Id.* at 1547. The company also bears "hidden costs," "including the costs of diverted managerial time, possible stigma, and damage to reputation." *Id.* at 1558-1559. When these costs are aggregated, "the sum may often exceed the net recovery to the class." *Ibid.*; see INTERIM REPORT at 79 (expressing doubt "that there is any positive recovery in the average securities class action").

In sum, securities fraud class action settlements are "largely paid by diversified shareholders to diversified shareholders and thus represen[t] a pocket-shifting wealth transfer that compensates no one in any meaningful sense and that incurs substantial wasteful transaction costs in the process."

INTERIM REPORT at 79; see Coffee, *supra*, 106 COLUM. L. REV. at 1583 ("Rule 10b-5 litigation in the secondary market 'stock drop' context essentially produces pocket-shifting wealth transfers that injure shareholders and do not protect the public interest"). See also Alexander, *supra*, 48 STAN. L. REV. at 1503: settlements "amount to transferring money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick up."

E. Weeding Out Weak Section 10(b) Claims At The Dismissal Stage Serves The Policies Underlying The Securities Laws.

Section 10(b) suits of this kind provide shareholders with little—if any—net compensatory benefit. Furthermore, their "deterrent function" is questionable "because virtually all the costs fall on the corporation and its insurer, which means they are ultimately borne by the shareholders." INTERIM REPORT at 78; Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 952 (1993) ("the deterrent effect is weak" when "the merits of claims" are "irrelevant to their initiation or settlement values"). Accordingly, requiring plaintiffs to satisfy rigorous scienter pleading standards will not undermine the deterrence and compensation policies of the securities laws. Other remedies are available that amply protect investors from corporate misrepresentations and non-disclosures without causing the harms and transaction costs we have described.

SEC regulations impose stringent reporting obligations. Corporations must file regular financial statements. 15 U.S.C. §§ 7241, 7243; 18 U.S.C. § 1349. Issuers also must file Form 8-K reports on any of a host of material corporate events, including agreements, acquisitions, disposition of assets, off-balance sheet financial obligations, and changes in officers or directors. SEC, Release No. 33-8400, 69 Fed. Reg. 15594 (2004). To enforce these disclosure obligations the SEC may obtain injunctive relief, cease-and-desist orders,

orders barring or suspending individuals from serving as an officer or director of an issuer of securities, and large civil penalties, including disgorgement of gains. 15 U.S.C. §§ 78u, 78u-3; see *SEC* v. *First Jersey Sec.*, 101 F.3d 1450 (2d Cir. 1996) (requiring disgorgement of $75 million). The SEC may earmark penalties and amounts disgorged "for the benefit of the victims" of the violation. 15 U.S.C. § 7246(a).

In addition, a person who willfully and knowingly makes a false or misleading statement of material fact may be held criminally liable and sentenced to imprisonment for 20 years and multi-million dollar fines. 15 U.S.C. § 78ff. Insiders who trade with knowledge of material information that has not been disclosed to the public face civil penalties of three times the profit gained or loss avoided. *Id.* § 78u-1. The Securities Act authorizes similar remedies for misstatements made in connection with the registration of securities, for which liability may be established without proof of scienter. *Id.* §§ 77t, 77y.

The SEC is not reluctant to use its powers. Former Chairman Richard Breeden described the goal of SEC enforcers as leaving securities law violators "naked, homeless, and without wheels." Eisenberg, *Enforcement Issues and Litigation*, 21 SEC. REG. L.J. 421, 421 (1994). In the aftermath of the bubble and recent corporate insolvencies, the Commission's 900-strong enforcement staff has shown extraordinary vigor. During fiscal year 2006 alone, the SEC initiated 914 investigations of possible violations of the securities laws and brought 218 suits and 356 administrative proceedings against issuers and financial service providers. The SEC obtained orders requiring the payment of more than $3.3 billion in disgorgement and penalties from securities law violators. SEC, 2006 PERFORMANCE AND ACCOUNTABILITY REPORT at 8, available at http://tinyurl.com/ygyfv8. In addition, the Department of Justice's Corporate Fraud Task Force has charged over 1,300 defendants and obtained over 1,000 guilty pleas and convictions since it was formed in July 2002. See Department of Justice, Fact Sheet: Corporate Fraud Task

Force (Aug. 9, 2006), available at http://tinyurl.com/yhj2v2. State prosecutors and blue sky officials may bring their own overlapping enforcement actions, and in cases involving the financial services industry self-regulatory organizations like the National Association of Securities Dealers ("NASD") and the New York Stock Exchange ("NYSE") enforce regulations that implement and supplement the securities laws.[2]

Securities market participants are hemmed in by an array of governmental powers, civil and criminal, that curb unlawful practices and compensate non-speculative injuries. As Judge Friendly observed, "[t]he important thing is to stop the evil conduct" and "an injunction," "fines," or other sanctions imposed at the behest of expert regulators achieve that purpose without "ruin[ing] innocent stockholders," "produc[ing] blackmail settlements," or "deterring desirable conduct." FRIENDLY, *supra*, at 120. Accord *Piper* v. *Chris Craft*, 430 U.S. 1, 40 & n.26 (1977) ("injunctive relief * * * is apt to be the most efficacious form of remedy" for securities law violations). Together, these checks curb unlawful practices and compensate genuine injuries. Given the availability of these remedies, there is no reason for this Court to allow Section 10(b) suits to proceed on the basis of conclusory allegations and speculative theories, as permitted by the liberal scienter pleading standards endorsed by the Seventh Circuit.

III. THE SEVENTH CIRCUIT SET THE THRESHOLD FOR PLEADING SCIENTER FAR TOO LOW.

Under any plausible reading of the PSLRA's strong inference standard for pleading scienter, the allegations here do not pass muster.

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[2] *E.g.*, NASD Notice to Members 99-86, *Imposition and Collection of Monetary Sanctions* (Oct. 1999), available at http://tinyurl.com/y3slbo (discussing fines, restitution, and disgorgement); see also NYSE Information Memo 05-77, *Factors Considered by the NYSE Division of Enforcement in Determining Sanctions* (Oct. 7, 2005), available at http://tinyurl.com/y3ro8p.

1. This Court's decisions establish two fundamental rules of pleading that bear decisively on this case. First, a complaint must allege facts, not merely conclusions, that show the plaintiff is entitled to relief under the governing substantive law. Second, it is the facts alleged, not unalleged facts that the plaintiff might later prove, that must support the claim for relief.

When a defendant tests the legal sufficiency of a pleading by filing a motion under Rule 12(b)(6), courts accept the *facts* alleged in the complaint as true for purposes of evaluating whether the complaint "state[s] a claim upon which relief can be granted." Fed. R. Civ. P. 12(b)(6); see *Leatherman* v. *Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 164 (1993). By contrast, courts need not accept the truthfulness of allegations that are merely conclusions, characterizations, or inferences.[3]

Policing this distinction between well-pleaded facts and conclusory assertions and inferences is necessary to ensure that a complaint "provide[s] the defendant with 'fair notice of what the plaintiff's claim is and the grounds upon which it rests.'" *Dura Pharms.*, 544 U.S. at 346 (quoting *Conley* v. *Gibson*, 355 U.S. 41, 47 (1957)). As Judge Boudin observed:

> [T]he price of entry, even to discovery, is for the plaintiff to allege a *factual* predicate concrete enough to warrant further proceedings, which may be costly and burdensome. Conclusory allegations in a complaint, if they stand alone, are a danger sign that the plaintiff is engaged in a fishing expedition.

DM Research, Inc. v. *Coll. of Am. Pathologists*, 170 F.3d 53, 55 (1st Cir. 1999).

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[3] See, *e.g.*, *Papasan* v. *Allain*, 478 U.S. 265, 286 (1986); *Veney* v. *Wyche*, 293 F.3d 726, 730 (4th Cir. 2002); *Dry* v. *United States*, 235 F.3d 1249, 1255 (10th Cir. 2000); *Doug Grant, Inc.* v. *Greate Bay Casino Corp.*, 232 F.3d 173, 184 (3d Cir. 2000); *In re Sofamor Danek Group, Inc.*, 123 F.3d 394, 400 (6th Cir. 1997).

Accordingly, "a complaint must allege, at a minimum, a sufficient factual predicate * * * to demonstrate a reasonable basis for inferring that the alleged conduct may be wrongful." Brief for the United States as Amicus Curiae Supporting Petitioners at 6, *Bell Atl. Corp.* v. *Twombly*, No. 05-1126 (Aug. 25, 2006) ("U.S. *Twombly* Br."); see *Warth* v. *Seldin*, 422 U.S. 490, 504 (1975). Furthermore, when testing the sufficiency of a complaint, "[i]t is not * * * proper to assume that the [plaintiff] can prove facts that it has not alleged." *Associated Gen. Contractors of Cal., Inc.* v. *Cal. State Council of Carpenters*, 459 U.S. 519, 526 (1983); see also *Wilson* v. *Schnettler*, 365 U.S. 381, 383 (1961).

Courts may consider "the potential magnitude of the case, and the policies behind the securities laws," in deciding whether to dismiss a complaint under Rule 12. U.S. *Twombly* Br. at 13. Thus, where "a case involves a 'potentially massive factual controversy,'" courts retain the power to require "more 'specificity in pleading.'" *Id.* at 17 (quoting *Associated Gen. Contractors*, 459 U.S. at 528 n.17). Using that power in sprawling securities fraud class actions is particularly appropriate for two reasons. First, because the scienter element of a securities fraud claim "critically distinguishes innocuous * * * conduct from wrongdoing, allegations concerning that element must be concrete, rather than conclusory." *Id.* at 12. Second, failing to require concrete allegations "would permit a plaintiff 'with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence.'" *Dura Pharms.*, 544 U.S. at 347.[4]

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[4] See also *Reiter* v. *Sonotone Corp.*, 442 U.S. 330, 345 (1979) (encouraging district courts to "use the tools available" to avoid "administrative chaos, class-action harassment, or 'windfall' settlements"); *Davis* v. *Passman*, 442 U.S. 228, 237 n.15 (1979) ("sufficient detail must be given so that the defendant, and the court, can

2. These ordinary pleading principles apply *a fortiori* to the scienter requirement under the PSLRA because Congress has "unequivocally raise[d] the bar" for pleading that element. Pet. App. 18a. The PSLRA requires that a complaint "state *with particularity* facts giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added). This heightened standard "alters the normal operation of inferences under Fed. R. Civ. P. 12(b)(6)." *In re Digital Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004). To give it effect, plaintiffs in a case covered by the PSLRA must plead facts that strongly tend to exclude the possibility that the defendant acted with an innocent state of mind. See Pet. 23-25; Pet. App. 23a; see generally *Matsushita Elec. Indus. Co.* v. *Zenith Radio Corp.*, 475 U.S. 574, 588 (1986).

A contrary rule that requires district judges "to consider only inferences favorable to [plaintiffs'] position" would "eviscerate the PSLRA's strong inference requirement by allowing plaintiffs to plead in a vacuum." *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 896 (9th Cir. 2002); see also *In re Credit Suisse First Boston*, 431 F.3d 36, 51 (1st Cir. 2005) (Rule 12 "does not require the court, in a PLSRA case, to turn a blind eye to the universe of possible conclusions stemming from a given fact or set of facts"); *Pirraglia* v. *Novell, Inc.*, 339 F.3d 1182, 1187 (10th Cir. 2003) ("Whether an inference is a strong one cannot be considered in a vacuum"). It would allow any competent plaintiffs' lawyer to establish a strong inference of scienter through artful pleading and "would thwart Congress's basic purpose in raising the bar in the first place; namely, to eliminate abusive and opportunistic securities litigation." *Gompper*, 298 F.3d at 897.

3. When the Court disregards conclusory assertions and focuses on the facts actually alleged, the complaint in this case does not come close to supporting a strong inference of

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obtain a fair idea of what the plaintiff is complaining, and can see that there is some legal basis for recovery").

scienter. The Seventh Circuit analyzed four categories of allegedly false statements by Tellabs' CEO, Richard Notebaert, to determine whether the complaint adequately alleged scienter. Pet. App. 10a, 22a. The petition thoroughly discusses each category (at 7-12, 26-28). Two examples are sufficient to show how badly the Seventh Circuit misperceived the governing pleading standard.

First, the complaint alleges that Notebaert overstated the demand for Tellabs' TITAN 5500 product in February and March 2001. Pet. App. 12a. The complaint appears to acknowledge, however, that information about the decline emerged over several months. It does not specify when external and internal reports documenting the decline were distributed, much less when (if at all) Notebaert saw those reports. Pet. App. 65a. Thus, plaintiffs have alleged no facts creating a strong inference that Notebaert had knowledge contrary to his general optimistic statements. And it is improper to assume they could prove unalleged facts at trial.

The Seventh Circuit observed that an internal report revealing the drop in demand was written sometime in March 2001. Pet. App. 23a. But the statements that the Seventh Circuit identified as false were made in February and on March 8. *Id.* at 12a. The only subsequent statement it could find was a remark in April about growing demand for Tellabs' services generally. *Id.* at 23a. On April 6, Tellabs disclosed an unanticipated drop in TITAN 5500 orders during the last two weeks of March and lowered its revenue projections accordingly. Pet. 27. These facts do not strongly tend to exclude the possibility that Notebaert made his positive statements without knowledge that demand had declined.

Second, the complaint alleges that Tellabs inflated its financial results for the fourth quarter of 2000 by engaging in "channel stuffing"—inducing purchasers to buy TITAN 5500s earlier than in the normal course. Pet. App. 13a, 55a-59a; *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 202 (1st Cir. 1999). It alleges that Notebaert knew about the channel

stuffing and worked with sales personnel to effect it. Pet. App. 25a. As the complaint defines channel stuffing, however, it is a label that applies to legitimate discounting, which is desirable and efficient conduct, as well as to illegitimate practices. Pet. 28; *Greebel*, 194 F.3d at 203 ("there may be any number of legitimate reasons for attempting to achieve sales earlier"); see also *Broudo* v. *Dura Pharms., Inc.*, 339 F.3d 933, 940 (9th Cir. 2003), *rev'd on other grounds*, 544 U.S. 336 (2005). Accordingly, as the district court held and the Eleventh Circuit recently confirmed, the general allegation that Notebaert promoted channel stuffing does not establish scienter. Pet. App. 74a; *Garfield* v. *NDC Health Corp.*, 466 F.3d 1255, 1265 (11th Cir. 2006).

Plaintiffs do allege that some of the channel stuffing consisted of illegitimate fabrication of purchase orders by Tellabs employees, but they do not allege that Notebaert had any knowledge of such fabrication. Thus, they have not pleaded particular facts that strongly tend to exclude the possibility that Notebaert acted with an innocent state of mind.

4. The Seventh Circuit's decision may not be upheld based on generalized allegations that Notebaert had the "motive and opportunity" to commit securities fraud. Some courts have adhered to a pre-PSLRA rule first adopted by the Second Circuit that allows plaintiffs to establish scienter "by pleading either motive and opportunity or strong circumstantial evidence of recklessness or conscious misbehavior." *Novak* v. *Kasaks*, 216 F.3d 300, 309-310 (2d Cir. 2000). The "motive and opportunity" test was flawed even before the PSLRA because it "'lower[ed] the bar for securities fraud cases below that mandated by * * * *Hochfelder*.'" *Bryant* v. *Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir. 1999). Almost "every highly ranked executive of a company could be said to have the motive and opportunity to profit by misstatements." *Fla. State Bd.* v. *Green Tree Fin. Corp.*, 270 F.3d 645, 655 (8th Cir. 2001); see *Bryant*, 187 F.3d at 1286 ("Greed is a ubiquitous motive, and corporate insiders and upper management always have opportunity to lie and ma-

nipulate"). By presuming that "anyone who has the chance to profit by wrongdoing is likely to do so," the motive and opportunity test enables plaintiffs to evade dismissal in virtually all Section 10(b) suits. *Fla. State Bd.*, 270 F.3d at 655.

To the extent that the motive and opportunity test was ever proper, it is now clear that "allowing private securities class actions to proceed to discovery upon bare allegations of motive and opportunity would upset the delicate balance of providing a remedy for genuine fraud while preventing abusive strike suits that the [PSLRA] sought to achieve." *Bryant*, 187 F.3d at 1286. Indeed, Congress expressly rejected a proposal to codify the motive and opportunity test, explaining that it "intend[ed] to strengthen existing pleading requirements" and thus "chose not to include in the pleading standard certain language relating to motive [and] opportunity." H.R. Conf. Rep. at 41 & n.23; see *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 979 (9th Cir. 1999) (Congress "rejected the 'motive and opportunity'" test). Accordingly, plaintiffs must plead facts that give rise to a "strong inference" that the defendant acted with "intent to deceive, manipulate, or defraud" in order to avoid dismissal under the PSLRA. *Hochfelder*, 425 U.S. at 193.[5]

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[5] This Court has "explicitly left open the question of whether recklessness satisfies the scienter requirement." *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 378 n.4 (1983) (citing *Hochfelder*, 425 U.S. at 194 n.12). In "'an area that demands certainty and predictability,'" *Central Bank*, 511 U.S. at 188, the recklessness standard is "too amorphous" and "belies the existence of a bright line test." 3 HAZEN, THE LAWS OF SECURITIES REGULATION § 12.8, at 258, 261 (5th ed. 2005). This "uncertainty" has caused some "reluctan[ce] to grant summary judgment in 10b-5 cases where scienter is a contested issue," *id.* at 261, and thus undermines Congress's intent in enacting the PSLRA. Accordingly, this Court should require plaintiffs to plead facts that give rise to a strong inference that the defendant acted with intent to deceive in order to survive a motion to dismiss. See *Dirks*, 463 U.S. at 663 n.23 (Section 10(b) requires "'intent to deceive'").

5. The Seventh Circuit erred by suggesting that heightened pleading standards applied by other circuits "could potentially infringe upon plaintiffs' Seventh Amendment rights." Pet. App. 20a. The Seventh Amendment does not bar Congress from specifying a procedure that may incidentally result in a case being decided by a court rather than a jury. See *Leatherman*, 507 U.S. at 168 (Congress may create heightened pleading standards); *Swierkiewicz* v. *Sorema N.A.*, 534 U.S. 506, 515 (2002) (same); *Galloway* v. *United States*, 319 U.S. 372, 389-390 (1943) (holding that a directed verdict practice approved by Congress does not violate the Seventh Amendment); Fed. R. Civ. P. 9(b) (requiring plaintiffs to plead "the circumstances constituting fraud or mistake * * * with particularity"); see also 8 MOORE'S FEDERAL PRACTICE § 38.12 (3d ed. 2006) (the "Seventh Amendment Does Not Regulate Matters of Pleading and Practice").

CONCLUSION

The judgment of the court of appeals should be reversed and the district court's judgment dismissing the complaints with prejudice reinstated.

Respectfully submitted.

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No. 06-484

In the Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD C. NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF FOR THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AND THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF THE *AMICI CURIAE*

The Securities Industry and Financial Markets Association (SIFMA) is a trade association that results from the November 1, 2006 merger of the Securities Industry Association and The Bond Market Association. It brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that expand and improve markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests in the United States and globally. It has offices in New York, Washington, D.C., and London.

The Chamber of Commerce of the United States of America ("Chamber") is the world's largest business federation. The Chamber's underlying membership includes more than three million companies and professional organizations of every size, in every industry sector, and from every region of the country. An important function of the Chamber is to represent the interests of its members in matters before Congress, the Executive Branch, and the courts. To that end, the Chamber regularly files *amicus curiae* briefs in cases that raise issues of vital concern to the nation's business community.[1]

The question presented here—the proper test for determining the sufficiency of scienter allegations in securities fraud cases—is an issue of recurring importance to the financial industry and to investors. *Amici* have a vital interest in ensuring that the uniform standards of the Private Securities Litigation Reform Act ("PSLRA"), which Congress passed

[1] Pursuant to Rule 37.6, *amici* affirm that no counsel for a party authored this brief in whole or in part and that no person other than *amici* and their counsel made a monetary contribution to its preparation or submission. The parties' letters consenting to the filing of this brief have been filed with the Clerk's office.

to curb vexatious litigation, are not defeated by the inability of federal courts of appeals to agree on how those standards should be applied. *Amici* believe that the experience of their members will assist the Court in assessing the harm that results from the Seventh Circuit's lax approach to scienter.

SUMMARY OF ARGUMENT

To avoid dismissal, the PSLRA requires that securities fraud plaintiffs plead "with particularity" facts giving rise to a "strong inference" of scienter. 15 U.S.C. § 78u-4(b)(2). Because the courts of appeals are hopelessly divided over the meaning of this frequently litigated standard, see Part I, *infra*, deficient complaints like the one in this case often escape dismissal. That result frustrates the PSLRA's goal of curbing abusive securities litigation, which has harmful consequences for the national economy. See Part II, *infra*. This Court's review is needed now.

The Seventh Circuit held that plaintiffs' complaint met the strong inference of scienter requirement because a reasonable person "could infer" scienter from the pleaded facts. Pet. App. 20a. The Court should reject that overly permissive test. As explained below, the Seventh Circuit's scienter test moves in the opposite direction from that chosen by Congress, significantly easing plaintiffs' burden and thereby encouraging the abusive strike suits that the PSLRA set out to prevent with heightened pleading requirements. The lax "could infer" test will also harm defendants and the markets without providing significant enforcement benefits. Given the many remedies available for alleged fraud, there is no reason for this Court to permit private suits based on conclusory allegations of scienter. When one disregards such assertions and focuses solely on the facts actually alleged, this complaint does not pass muster even under ordinary pleading standards, much less the PSLRA's heightened standard. See Part III, *infra*.

ARGUMENT

I. THE OUTCOME OF THIS CASE TURNS ON A CIRCUIT SPLIT THAT THIS COURT SHOULD RESOLVE.

The circuits disagree about the role that competing inferences should play in deciding whether a plaintiff has alleged facts that give rise to a "strong inference" of scienter. Here, the Seventh Circuit rejected the approach of four other circuits, which consider only the "most plausible" of competing inferences. Pet. App. 20a (quoting *Helwig* v. *Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (en banc)); see Pet. 19. It favorably cited the Tenth Circuit's "facts that would convince a reasonable person" test, Pet. App. 21a (quoting *Adams* v. *Kinder-Morgan, Inc.*, 340 F.3d 1083, 1105 (10th Cir. 2003)), as well as the Second, Third, and Eighth Circuits' view that a strong inference arises when a defendant "had access to information" suggesting that his or her public statements were inaccurate. Pet. App. 23a (quoting *Florida State Bd. of Admin.* v. *Green Tree Fin. Corp.*, 270 F.3d 645, 665 (8th Cir. 2001)); see Pet. 20-21, 24. But the Seventh Circuit ultimately adopted a still more lax test, asking only whether a reasonable person "could infer" scienter from the pleaded facts. Pet. App. 20a.

This conflict cannot be dismissed as a quibble over differences in the language used to explain the strong inference of scienter standard. That standard is one of the most frequently litigated provisions of the PSLRA. Pet. 17. The lower courts' inability to agree on its meaning has damaged the effectiveness of the statute in a way that this Court should repair. Confusion about how the circuits' different tests apply in practice allows deficient complaints to escape dismissal—as occurred here, see Part III, *infra*—frustrating Congress's goal of a heightened and uniform pleading standard.

This Court should grant certiorari to resolve the conflict among the circuits and announce clear rules that can be applied consistently from case to case. As the independent, bi-

partisan Committee on Capital Markets Regulation recently concluded, "there needs to be greater clarity to private litigation under Rule 10b-5" regarding the definition of scienter because "[n]eedless uncertainty will drive participants to competitor market centers." Interim Report of the Committee on Capital Markets Regulation vii, xii, 80-81 (Nov. 30, 2006), available at http://tinyurl.com/u4qaz ("Interim Report"). *Amici* submit that the correct scienter standard requires dismissal unless the facts alleged strongly tend to exclude innocent explanations for the challenged conduct. But under *any* reasonable reading of the strong inference standard the facts pleaded here do not pass muster. See Part III, *infra*. The Seventh Circuit's "could infer" test is far too lax and should be rejected.

II. THE UNAMBIGUOUS CONGRESSIONAL INTENT UNDERLYING THE PSLRA REQUIRES A STRONGER SCIENTER STANDARD.

The Seventh Circuit held that plaintiffs need only plead facts from which a reasonable person "could infer" scienter. Pet. App. 20a. But the PSLRA was meant to create a "uniform and more stringent" scienter pleading requirement, H.R. Conf. Rep. No. 104-369, at 41 (1995), reprinted in 1995 U.S.C.C.A.N. 730 ("H.R. Conf. Rep."), which bars such speculative claims. Accordingly, this Court should reject the Seventh Circuit's test and insist on a more rigorous standard that screens out conjectural claims of scienter.

A. The Historical Background Of The PSLRA Demonstrates The Importance Of A Stronger Standard.

In determining Congress's goal in enacting the PSLRA, it is necessary to begin with the problems that prompted enactment of legislation reforming securities litigation. "[A]s a matter of policy," this Court has long rejected "expansive imposition of civil liability" for securities fraud under Section 10(b) because that implied cause of action "presents a danger of vexatiousness different in degree and in kind from

that which accompanies litigation in general." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739-740 (1975); see *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Dabit*, 126 S. Ct. 1503, 1510 (2006). In particular, this Court has recognized that, because of the risk of a jury verdict holding defendant liable for huge market losses, "even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success" if the plaintiff is able to "prevent the suit from being resolved against him by dismissal or summary judgment." And the threat of costly and disruptive discovery adds a further "*in terrorem* increment" to the settlement value of a suit. *Blue Chip Stamps*, 421 U.S. at 740-741.

Accordingly, this Court has repeatedly limited the scope of private securities damages actions to curtail their coercive potential and make meritless claims easier "'to dispose of before trial.'" *Blue Chip Stamps*, 421 U.S. at 742-743; see *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) (requiring proof of scienter, not mere negligence); *TSC Indus.* v. *Northway, Inc.*, 426 U.S. 438 (1976) (rejecting lax definition of materiality); *Santa Fe Indus.* v. *Green*, 430 U.S. 462 (1977) (limiting Section 10(b) to manipulative or deceptive conduct); *Schreiber* v. *Burlington Northern, Inc.*, 472 U.S. 1 (1985) (confining Section 14(e) to manipulative acts that involve misrepresentation or nondisclosure); *Central Bank of Denver* v. *First Interstate Bank*, 511 U.S. 164, 189 (1994) (rejecting aiding and abetting claims under Section 10(b) because they would engender "uncertainty and excessive litigation").

Despite these and other judicially imposed limitations, "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and 'manipulation by class action lawyers of the clients whom they purportedly represent' * * * resulted in extortionate settlements, chilled any discussion of issuers' future prospects, and deterred qualified individuals from serving on boards of directors." *Dabit*, 126 S. Ct. at

1510-1511 (quoting H.R. Conf. Rep. at 31). Congress responded to this "significant evidence of abuse," which undermined "American capital markets" and caused "serious injuries to innocent parties" who were "forced to pay exorbitant 'settlements.'" H.R. Conf. Rep. at 31-32. Congress passed the PSLRA in 1995 "to protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation." *Ibid.*

A key part of Congress's "effort to curb these perceived abuses" was heightened pleading requirements for Section 10(b) claims, including the strong inference of scienter standard. *Dabit*, 126 S. Ct. at 1511. The flood of Section 10(b) class actions filed since the stock market bubble burst in 2000 confirms that the need for a protective scienter pleading standard remains acute. See Pet. 17. The Committee on Capital Markets Regulation recently observed that such class action lawsuits have "been accompanied by a rise in settlement sizes to new and unprecedented levels." Interim Report at 75 (capitalization altered).

Nevertheless, the Seventh Circuit has adopted an approach to scienter that moves headlong in the opposite direction, significantly easing plaintiffs' burden and thereby encouraging abusive strike suits. Given the availability of nationwide service of process, see 15 U.S.C. §§ 77v & 78aa, most future suits are likely to be brought in the Seventh Circuit, where plaintiffs now have a better prospect of avoiding dismissal and thus obtaining larger settlements. Because allowing the Seventh Circuit's approach to persist "would bring about harm of the very sort the [PSLRA] seek[s] to avoid," the Court should take this opportunity to review and reject it. *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336, 347 (2005).

B. The Seventh Circuit's Lax "Could Infer" Test Would Do More Harm Than Good.

The Seventh Circuit's permissive scienter pleading rule "will ultimately result in more harm than good." *Hochfelder*,

425 U.S. at 214 n.33 (quoting *Blue Chip Stamps*, 421 U.S. at 747-748). That rule substantially harms defendants and the markets generally while providing few countervailing enforcement benefits.

1. By relaxing the PSLRA's strict pleading standards, the Seventh Circuit's decision will increase the pressure on defendants to settle even insubstantial claims and thus encourage plaintiffs to file them. Empirical studies have shown that "[f]or practical purposes, the merits do not matter" in Section 10(b) class actions that proceed beyond the dismissal stage. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 501 (1991) (Section 10(b) became "a grotesquely inefficient form of insurance against large stock market losses" that "encourages the filing of more and weaker suits"). Bet-the-company damages claims and huge litigation costs force defendants to pay enormous settlements that are neither "voluntary," because the risks mean that trial is not "a practically available alternative," nor "accurate," because "the strength of the case on the merits has little or nothing to do with determining the amount of the settlement." *Id.* at 499; accord Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J. L. ECON. & ORG. 55 (1991).

The costs of abusive litigation are "'an Achilles heel for our economy.'" Deborah Solomon, *Treasury's Paulson Warns of the Costs of Rules Overlap*, WALL ST. J., Nov. 21, 2006, at A2 (quoting Secretary of Treasury). These costs are borne disproportionately by the most innovative and entrepreneurial companies, which are targeted because the volatility in their share price attracts the attention of the plaintiffs' bar.[2] And abusive securities class action litigation has enor-

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[2] See *Securities Litigation Reform Proposals: Hearings on S. 240, S. 667, and H.R. 1058 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 109 (1995) (testimony of George Sollman on behalf of the American Electronics Association) (estimating that about half of

mously destructive ripple effects. The risk of open-ended liability deters competent individuals from serving as independent directors on corporate boards. S. Rep. No. 104-98, at 21 (1995), reprinted in 1995 U.S.C.C.A.N. 679. That risk also extends to investment bankers and other professionals essential to capital raising and efficient market operation, driving up the cost of their services. Accounting firms, often named as deep-pocket defendants, become less willing to perform auditing services. *Id.* at 21-22. "[N]ewer and smaller companies," in particular, are often unable to obtain high-quality professional services, because their "business failure would generate securities litigation against the professional, among others." *Central Bank*, 511 U.S. at 189; H.R. Rep. No. 104-50, at 20 (1995) ("Fear of litigation keeps companies out of the capital markets," and "businesses suffer as auditors and directors decline engagements and board positions"); Alexander, *supra*, 43 STAN. L. REV. at 570-573. D&O insurers must increase premiums or stop underwriting policies altogether. S. Rep. No. 104-98, at 21. And foreign companies are deterred from listing their securities on domestic stock exchanges.[3]

Lax scienter pleading rules also disserve the core goal of the securities laws: ensuring the free flow of information critical to investors and to market efficiency. H.R. Conf. Rep. at 42 ("Abusive litigation severely affects the willingness of

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the top 100 companies in Silicon Valley have been subjected to a securities class action lawsuit at least once).

[3] See Paul Atkins, *A Serious Threat to Our Capital Markets*, WALL ST. J., June 10, 2006, at A12 (SEC Commissioner Atkins explains that "[l]itigation risks * * * lessen the international appetite for our capital markets"); *Common Sense Legal Reform Act: Hearings on H.R. 10 Before the Subcomm. on Telecommunications and Finance of the H. Comm. on Commerce*, 104th Cong., 1st Sess. 221, 224 (1995) (statement of former SEC Chairman Richard C. Breeden) ("Based on conversations with potential issuers of securities all over the world, the fear of litigation inhibits foreign firms from participating in the U.S. market[s]").

corporate managers to disclose information to the marketplace"). A firm that discloses information "inevitably takes the risk of excessive optimism and excessive pessimism." EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 339 (1991). A "rule penalizing excesses in either direction would lead to silence" about a company's prospects, paradoxically creating an environment of secrecy in which dishonest practices can thrive. *Ibid.*; Pet. App. 8a.

Investors particularly "want the issuer's own view of its future." KRIPKE, THE SEC AND CORPORATE DISCLOSURE 25 (1979). Broad scienter theories bring the threat of massive liabilities for such prognostications, however, creating a potent disincentive to discuss the company's future. See Backman, *Forward-Looking Statements and Cautionary Language After the 1995 Reform Act*, in PLI, SAILING IN "SAFE HARBORS" 153, 158-159, 208-209 (1997). Corporate managers' communications with analysts, which are "necessary to the preservation of a healthy market," are also muzzled by the risk of Section 10(b) suits based on conclusory scienter allegations. *Dirks* v. *SEC*, 463 U.S. 646, 658-659 (1983); see SEC, Release No. 33-7881, 65 Fed. Reg. 51716, 51718 n.19 (2000) ("fear of legal liability" "chill[s]" communications with analysts). When SEC disclosure requirements do not make silence an option, issuers may respond to the threat of unconstrained liability with defensive disclosure that "bur[ies] the shareholders in an avalanche of trivial information." *TSC*, 426 U.S. at 448; see *Basic Inc.* v. *Levinson*, 485 U.S. 224, 231 (1988).

Allowing Section 10(b) suits to proceed on the basis of speculative scienter theories thus detracts from the quantity and quality of information received by investors. In adopting more stringent limits on private damages actions in the PSLRA, Congress meant to address the concern that Section 10(b) suits had "'chill[ed]' the 'robustness and candor of disclosure.'" H.R. Conf. Rep. at 43; see H.R. Rep. No. 104-50, at 19 ("abuse of the 10b-5 system * * * deters the voluntary disclosure of information that the Federal securities laws

were designed to promote"); S. Rep. No. 104-98, at 5. This Court has refused to interpret the Exchange Act in ways that undermine the free flow of information, and it should do so once again here. *Dirks*, 463 U.S. at 658-659.

2. As the Committee on Capital Markets Regulation has explained:

> The modern securities class action lawsuit creates a heavy burden for public companies; without a substantial social benefit, this burden cannot be justified. * * * [H]owever, the public value of the securities class action litigation is questionable.

Interim Report at 78.

Speculative claims of fraud are of little benefit to shareholders—even to shareholder plaintiffs. Every delayed announcement of accurate firm information produces both winners (who sold during the period of inflation) and losers (who bought then and sold after disclosure of the truth). POSNER, ECONOMIC ANALYSIS OF THE LAW 489 (5th ed. 1998). "Over the long run, any reasonably diversified investor will be a buyer half the time and a seller half the time" and will not benefit from "a legal rule that forces his winning self to compensate his losing self over and over." EASTERBROOK & FISCHEL, *supra*, at 340; see Interim Report at 79; Thakor, *et al.*, *The Economic Reality of Securities Class Action Litigation* 1 (U.S. Chamber Institute for Legal Reform 2005), available at http://tinyurl.com/ua8uq (explaining that diversified institutional investors in particular are for this reason overcompensated as a result of litigation).

Such wealth transfers also entail significant transaction costs. To the extent that class members still own shares in the issuer, "payments by the corporation to settle a class action amount to transferring money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick up." Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1503 (1996); see Interim Report at 79 (discussing the fees of plaintiffs' attorneys, defense

costs, and the high cost of insurance). Given that "the average securities class action settles for between two percent and three percent of the investors' economic losses," "it is not clear that there is any positive recovery in the average securities class action" after accounting for these transaction costs. Interim Report at 79.

This Court need have no fear that requiring Section 10(b) plaintiffs to satisfy a rigorous, non-speculative scienter standard, as Congress intended, will undermine the deterrence and compensation policies of the securities laws or hobble their enforcement. Meritorious private securities fraud suits, of course, will meet the scienter standard. The "potential deterrent function" of allowing more suits is questionable "because virtually all the costs fall on the corporation and its insurer, which means they are ultimately borne by the shareholders." Interim Report at 78. Instead, other administrative and judicial remedies can be used to vindicate the relevant policies without causing the harms and transaction costs identified above.

For example, SEC regulations impose stringent reporting obligations on corporations, subject to SEC enforcement proceedings. Corporations must file quarterly and annual financial statements, which executives now must certify under threat of criminal penalty and disgorgement of their compensation and stock trading profits. 15 U.S.C. §§ 7241, 7243; 18 U.S.C. § 1349. Issuers also must file Form 8-K reports on any of a host of material corporate events, including agreements, acquisitions, disposition of assets, off-balance sheet financial obligations, and changes in officers or directors. SEC, Release No. 33-8400, 69 Fed. Reg. 15594 (2004).

The powers of the SEC to enforce these corporate disclosure obligations are substantial. The Commission may obtain injunctive relief, cease-and-desist orders, orders barring or suspending individuals from serving as an officer or director of an issuer of securities, and large civil penalties, including disgorgement of any gain. 15 U.S.C. §§ 78u, 78u-3. Un-

der the Sarbanes-Oxley Act, the SEC may earmark penalties and amounts disgorged "for the benefit of the victims" of the violation. 15 U.S.C. § 7246(a).

A person who willfully and knowingly makes a false or misleading statement of material fact may also be criminally liable and is subject to imprisonment for 20 years and multi-million dollar fines. 15 U.S.C. § 78ff. The Securities Act authorizes many similar remedies for misstatements made in connection with the registration of securities, for which liability may be established without proof of scienter. *Id.* §§ 77t, 77y.

During fiscal year 2006 alone, the SEC initiated 914 investigations of possible violations of the securities laws and brought 218 suits and 356 administrative proceedings against issuers and financial service providers. The Commission obtained orders requiring the payment of more than $3.3 billion in disgorgement and penalties from securities law violators.[4] In addition, the Department of Justice's Corporate Fraud Task Force has charged over 1,300 defendants and obtained over 1,000 guilty pleas and convictions since it was formed in July 2002.[5]

State officials may bring their own overlapping enforcement actions. Financial services industry self-regulatory organizations ("SROs"), such as the National Association of Securities Dealers and the New York Stock Exchange, also enforce regulations that implement and supplement the securities laws.[6] Together, all these checks curb unlawful prac-

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[4] SEC, 2006 PERFORMANCE AND ACCOUNTABILITY REPORT at 8, available at http://tinyurl.com/ygyfv8.

[5] See Department of Justice, Fact Sheet: Corporate Fraud Task Force (Aug. 9, 2006), available at http://tinyurl.com/yhj2v2.

[6] *E.g.*, NASD Notice to Members 99-86, *Imposition and Collection of Monetary Sanctions* (Oct. 1999), available at http://tinyurl.com/y3slbo (discussing fines, restitution, and disgorgement); see also NYSE Information Memo 05-77, *Factors*

tices and compensate injuries. Given the availability of these remedies, there is no reason for this Court to permit the conclusory allegations and speculative theories of scienter endorsed by the Seventh Circuit.

III. ORDINARY PLEADING RULES AND CASES ON COMPETING INFERENCES SET A SCIENTER PLEADING THRESHOLD HIGHER THAN THE SEVENTH CIRCUIT'S.

This Court should also reject the Seventh Circuit's "could infer" test because it allows complaints that do not satisfy even ordinary rules of notice pleading to escape dismissal. Under any reasonable reading of the strong inference standard the facts pleaded here do not pass muster.

1. This Court's decisions establish two fundamental rules of pleading that bear decisively on this case. First, a complaint must allege facts, not merely conclusions, that show the plaintiff is entitled to relief under the governing substantive law. Second, it is the facts alleged, not unalleged facts that the plaintiff might later prove, that must support the claim for relief.

When a defendant tests the legal sufficiency of a pleading by filing a motion under Rule 12(b)(6), courts accept the *facts* alleged in the complaint as true for purposes of evaluating whether the complaint "state[s] a claim upon which relief can be granted." Fed. R. Civ. P. 12(b)(6); see *Leatherman* v. *Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 164 (1993). By contrast, courts need not accept the truth of allegations that are merely conclusions, characterizations, or inferences.[7]

Considered by the NYSE Division of Enforcement in Determining Sanctions (Oct. 7, 2005), available at http://tinyurl.com/y3ro8p.

[7] See, *e.g.*, *Papasan* v. *Allain*, 478 U.S. 265, 286 (1986); *Veney* v. *Wyche*, 293 F.3d 726, 730 (4th Cir. 2002); *Dry* v. *United States*, 235 F.3d 1249, 1255 (10th Cir. 2000); *Doug Grant, Inc.* v. *Greate Bay Casino Corp.*, 232 F.3d 173, 184 (3d Cir. 2000); *In re Sofamor Danek Group, Inc.*, 123 F.3d 394, 400 (6th Cir. 1997).

Policing this distinction between well-pleaded facts, on the one hand, and conclusory assertions and inferences, on the other, is necessary to ensure that a complaint "provide[s] the defendant with 'fair notice of what the plaintiff's claim is and the grounds upon which it rests.'" *Dura Pharms.*, 544 U.S. at 346 (quoting *Conley* v. *Gibson*, 355 U.S. 41, 47 (1957)). As Judge Boudin stated in *DM Research, Inc.* v. *College of American Pathologists*:

> [T]he price of entry, even to discovery, is for the plaintiff to allege a *factual* predicate concrete enough to warrant further proceedings, which may be costly and burdensome. Conclusory allegations in a complaint, if they stand alone, are a danger sign that the plaintiff is engaged in a fishing expedition.

170 F.3d 53, 55 (1st Cir. 1999).

Accordingly, "a complaint must allege, at a minimum, a sufficient factual predicate * * * to demonstrate a reasonable basis for inferring that the alleged conduct may be wrongful." Brief for the United States as Amicus Curiae Supporting Petitioners at 6, *Bell Atlantic Corp.* v. *Twombly*, No. 05-1126 (Aug. 25, 2006) ("U.S. *Twombly* Br."); see *Warth* v. *Seldin*, 422 U.S. 490, 504 (1975). Furthermore, when testing the sufficiency of a complaint, "[i]t is not * * * proper to assume that the [plaintiff] can prove facts that it has not alleged." *Associated Gen. Contractors of Cal., Inc.* v. *California State Council of Carpenters*, 459 U.S. 519, 526 (1983); see also *Wilson* v. *Schnettler*, 365 U.S. 381, 383 (1961).

As this Court has held, Rule 12 preserves courts' power "to insist upon some specificity in pleading before allowing a potentially massive factual controversy to proceed." *Associated Gen. Contractors*, 459 U.S. at 528 n.17. Using that power in sprawling securities fraud class actions is particularly appropriate for two reasons. First, because the scienter element of a securities fraud claim "critically distinguishes innocuous * * * conduct from wrongdoing, allegations concerning that element must be concrete, rather than conclu-

sory." U.S. *Twombly* Br. at 12; *cf. Hochfelder*, 425 U.S. at 198-199. Second, failing to require concrete allegations "would permit a plaintiff 'with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence.'" *Dura Pharms.*, 544 U.S. at 347 (quoting *Blue Chip Stamps*, 421 U.S. at 741).[8]

2. These ordinary pleading principles apply *a fortiori* to the scienter requirement under the PSLRA because Congress has "unequivocally raise[d] the bar" for pleading that element. Pet. App. 18a. The PSLRA requires that a complaint "state *with particularity* facts giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added).

Several courts of appeals have acknowledged that this heightened pleading standard "alters the normal operation of inferences under Fed. R. Civ. P. 12(b)(6)." *In re Digital Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004); see Pet. 18-19 (collecting cases). But the courts of appeals cannot agree on a uniform approach for measuring whether the facts alleged satisfy the statutory standard—especially when those facts might support inferences of both an innocent and a culpable state of mind. See Part I, *supra*.

For the reasons discussed in Part II above, Congress limited the range of permissible inferences in a securities fraud

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[8] See also *Reiter* v. *Sonotone Corp.*, 442 U.S. 330, 345 (1979) (encouraging district courts to "use the tools available" to avoid "administrative chaos, class-action harassment, or 'windfall' settlements"); *Davis* v. *Passman*, 442 U.S. 228, 237 n.15 (1979) ("It is not enough to indicate merely that the plaintiff has a grievance but sufficient detail must be given so that the defendant, and the court, can obtain a fair idea of what the plaintiff is complaining, and can see that there is some legal basis for recovery") (internal quotation marks omitted).

case by requiring the plaintiff to plead particular facts giving rise to a strong inference of scienter. Given this statutory mandate, the strength of the scienter inference must be measured in light of any competing inference of an innocent mental state that arises from the pleaded facts. Thus, a plaintiff in a case covered by the PSLRA must plead facts that strongly tend to exclude the possibility that the defendant acted with an innocent state of mind. See generally *Matsushita Elec. Indus. Co.* v. *Zenith Radio Corp.*, 475 U.S. 574, 588 (1986). The Second, Third, and Eighth Circuits have correctly adopted this approach, requiring that the facts strongly suggest knowledge of falsity. Pet. 23-25; Pet. App. 23a.[9]

3. When the Court disregards conclusory assertions and focuses on the facts actually alleged, the complaint in this case does not come close to supporting a strong inference of scienter. The Seventh Circuit analyzed four categories of allegedly false statements by Tellabs' CEO, Richard Notebaert, to determine whether the complaint adequately alleged scienter with respect to each. Pet. App. 10a, 22a. The petition thoroughly discusses each category (at 7-12, 26-28). Two examples are sufficient here to show how badly the Seventh Circuit misperceived the governing pleading standard.

First, the complaint alleges that Notebaert overstated the demand for Tellabs' TITAN 5500 product in February and March 2001. Pet. App. 12a. The complaint appears to acknowledge, however, that information about the decline emerged over several months. It does not specify when external and internal reports documenting the decline were distributed, much less when (if at all) Notebaert reviewed those reports. Pet. App. 65a. Thus, plaintiffs have alleged no facts creating a strong inference that Notebaert had knowledge contrary to his general optimistic statements, and it is not

[9] As the petition points out (at 5, 23), the Second and Third Circuits also give weight to generalized allegations of motive and opportunity. Other courts of appeals have correctly rejected that method of analysis. See Pet. 23 n.4.

proper to assume that they could prove unalleged facts at trial.

The Seventh Circuit observed that an internal report revealing the drop was written sometime in March 2001. Pet. App. 23a. But the primary statements that the Seventh Circuit identified as false were made in February and on March 8 (*id.* at 12a). The only subsequent statement it could find was a remark in April about growing demand for Tellabs' services generally. *Id.* at 23a. On April 6, Tellabs disclosed an unanticipated drop in TITAN 5500 orders during the last two weeks of March and lowered its revenue projections accordingly. Pet. 27. These alleged facts do not strongly tend to exclude the possibility that Notebaert made his positive statements about the TITAN 5500 without knowledge that demand had declined.

Second, the complaint alleges that Tellabs inflated its financial results for the fourth quarter of 2000 by engaging in "channel stuffing"—inducing purchasers to buy TITAN 5500s earlier than in the normal course. Pet. App. 13a, 55a-59a; *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 202 (1st Cir. 1999). It alleges that Notebaert knew about the channel stuffing and worked with sales personnel to effect it. Pet. App. 25a. As the complaint defines channel stuffing, however, it is a label that applies to legitimate discounting, which is desirable and efficient conduct, as well as to illegitimate practices. Pet. 28; *Greebel*, 194 F.3d at 203 ("there may be any number of legitimate reasons for attempting to achieve sales earlier"); see also *Broudo* v. *Dura Pharms., Inc.*, 339 F.3d 933, 940 (9th Cir. 2003), *rev'd on other grounds*, 544 U.S. 336 (2005). Accordingly, as the district court held and the Eleventh Circuit recently confirmed, the general allegation that Notebaert promoted channel stuffing does not establish scienter. Pet. App. 74a; *Garfield* v. *NDC Health Corp.*, 466 F.3d 1255, 1265 (11th Cir. 2006).

Plaintiffs do allege that some of the channel stuffing consisted of illegitimate fabrication of purchase orders by

Tellabs employees, but they do not allege that Notebaert had any knowledge of such fabrication. Thus, they have not pleaded particular facts that strongly tend to exclude the possibility that Notebaert acted with an innocent state of mind. Accordingly, the district court properly dismissed plaintiffs' complaint.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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DECEMBER 2006

No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INC. ET AL.,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE STATES OF ARKANSAS, MICHIGAN, MISSISSIPPI, MISSOURI, NEW JERSEY, NEW MEXICO, AND RHODE ISLAND, AND THE COMMONWEALTH OF MASSACHUSETTS, AND THE PENNSYLVANIA PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM AND THE PENNSYLVANIA STATE EMPLOYEES' RETIREMENT SYSTEM AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF AMICUS CURIAE[1]

The Amici States, as guardians of the citizenry and as fiduciaries to the public servants who rely on them to prudently manage their retirement funds, have a paramount interest in the enforcement and proper interpretation of the securities laws. The Amici States, by their own laws, also give recognition to and confer both rights and responsibilities on corporations. Thus, the method for pleading scienter under the securities laws is of great importance to the Amici States.

The Amici States, and the Amici public pension funds, manage an aggregrate $400 billion invested in the public markets, and are among the largest public or private money managers in the United States. Combined, they manage the retirement plans for over 3.2 million active and retired public servants. Increasingly, the Amici States and public pension funds act as lead plaintiffs in securities class actions, and in the aggregate currently serve as lead plaintiffs in 26 pending securities class actions. As lead plaintiffs, Amici play a pivotal role in enforcing and deterring violations of the securities laws and in recovering losses for investors and pensioners victimized by fraud. As large public institutional investors, Amici are especially effective lead plaintiffs, just as Congress contemplated when revising the procedures for selecting lead plaintiffs as part of the Private Securities Litigation Reform Act of 1995.

The Court's decision in this case will greatly impact the Amici States' ability to fulfill their dual role as protectors of the public interest and fiduciaries of publicly managed funds.

INTRODUCTION

In 1995, Congress substantially revised the procedures governing the conduct of private securities litigation to minimize

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[1] Amici state that no counsel for any party authored this brief in whole or in part, and no person or entity other than amicus curiae, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. The parties' letters of consent to the filing of this brief have been lodged with the Clerk.

certain perceived abuses while still allowing meritorious claims to proceed. Among other significant changes, Congress tightened the pleading standards for complaints alleging securities fraud, requiring plaintiffs to allege facts "giving rise to a strong inference" of scienter. 15 U.S.C. § 78u-4(b)(2). The "strong inference" standard had first been created by the Second Circuit in 1979, and had been consistently interpreted by that court to mean facts sufficient to support a jury verdict for the plaintiff.

Although Congress imported the Second Circuit's language into the new statute and evinced its awareness of Second Circuit pleading requirements, Petitioners and their amici contend that the statutory "strong inference" requirement does not mirror the one created by the Second Circuit at all, but instead represents an entirely new pleading standard – one that has never been employed by any court, that appears nowhere in the legislative history, and that represents a radical departure from the pleading rules that have governed all federal cases since the adoption of the Federal Rules of Civil Procedure. Indeed, the standard proposed by Petitioners appears to have been invented out of whole cloth, for they do not cite a single authority to support their novel formulation. As for Amicus United States, its views on this matter appear to have evolved; in 1998 and 1999, the Securities and Exchange Commission argued before at least five courts of appeals that Congress codified the Second Circuit standard.

The arguments of Petitioners and their amici should be rejected. By its terms, the statute adopts Second Circuit law, and nothing in either the language or the legislative history suggests that Congress intended the drastic new regime that Petitioners and their amici propose. Though Petitioners argue that their new standard is necessary to avoid frivolous litigation, they do not even address why the Second Circuit's standard – identical to the standard sufficient to support a verdict at trial – when combined with the other provisions of the PSLRA, will not accomplish this result. Moreover, Petitioners' proposed standard would have the perverse effect of requiring courts to dismiss meritorious lawsuits. Congress could not have intended such a result.

I. THE PSLRA RELIES ON SEVERAL PROVISIONS TO EFFECTUATE ITS GOALS

In 1995, Congress enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 77z-1 to 78u-5. The Act was designed to minimize certain perceived abuses in securities litigation while simultaneously allowing meritorious cases to go forward. As Congress explained,

> Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely on government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs. This legislation seeks to return the securities litigation system to that high standard.

H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 31, at 31 (1995).

To eliminate frivolous litigation while preserving meritorious actions, Congress created a carefully balanced scheme that made several significant changes to securities litigation procedures, only one of which tightened the requirements for pleading the element of scienter. A proper interpretation of the scienter pleading standard must therefore take into account the fact that this provision is *not* the only protection that defendants have against baseless claims, as well as the fact that Congress did not intend to raise the pleading bar so high that legitimate claims would become impossible to pursue. *See Helwig v. Vencor, Inc.* 251 F.3d 540, 553 (6th Cir. 2001) (en banc) ("[T]he Reform Act would hardly serve its purpose 'to protect investors and to maintain confidence in the securities markets,' were it to become a choke-point for meritorious claims.") (citation omitted); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 30 (1st Cir. 2002) ("The statute was designed to erect barriers to frivolous strike suits, but not to make meritorious claims impossible to bring.").

One of the most significant changes was to eliminate the "race to the courthouse" by creating a set of procedures for determining the lead plaintiff and encouraging the participation of institutional investors, such as pension funds. 15 U.S.C. § 78u-4(a)(3)(B). Congress also placed limits on the use of so-called professional plaintiffs, 15 U.S.C. § 78u-4(a)(3)(B)(vi), and forbade the lead plaintiff from receiving compensation above that received by other class members, 15 U.S.C. § 78u-4(a)(4). Congress believed that these provisions would eliminate attorney-driven litigation and would permit the drafting of stronger, better-researched complaints. *See* H.R. Conf. Rep. No. 369, *supra*, at 32-35; *In re Cavanaugh*, 306 F.3d 726, 738 (9th Cir. 2002).

Next, to eliminate pressures on defendants to settle merely to avoid discovery costs, Congress created a mandatory stay of discovery until the resolution of any motions to dismiss. 15 U.S.C. § 78u-4(b)(3)(B); *see* H.R. Conf. Rep. No. 369, *supra*, at 37. Simultaneously, Congress imposed new pleading standards, requiring that all securities fraud complaints specifically identify false statements, the reasons why they are false, and, for allegations made on information and belief, "state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). Congress tightened the standards for allegations of scienter, as well, requiring that "the complaint . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. §78u-4(b)(2). For claims based on "forward-looking statements," an area believed particularly problematic, *see* H.R. Conf. Rep. No. 369, *supra*, at 42-43, Congress narrowed the substantive bases for liability. Although the circuits were in agreement that proof of recklessness would ordinarily satisfy the scienter element of a §10(b) claim, *see Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 343 (4th Cir. 2003), for forward-looking statements, Congress mandated that plaintiffs prove that the statement was made with "actual knowledge" of its falsity and created a special "safe harbor" for statements

accompanied by proper warnings. 15 U.S.C. § 78u-5. Finally, additional protections were provided at later stages of litigation: limits were placed on joint and several liability, and, at the conclusion of litigation, courts are now statutorily required to assess whether any party has violated Federal Rule of Civil Procedure 11(b). 15 U.S.C. §§ 78u-4(c),(f).

Courts have vigorously enforced the PSLRA's requirements. Despite plaintiffs' lack of access to formal discovery at the pleading stage, courts demand that plaintiffs identify specific internal reports, their contents, and who reviewed them, to show scienter. *See California Pub. Employees' Ret. Sys. v. Chubb Corp.*, 394 F.3d 126, 147 (3d Cir. 2004); *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 72-73 (2d Cir. 2001). In *Goldstein v. MCI WorldCom*, 340 F.3d 238 (5th Cir. 2003), for example, the Fifth Circuit dismissed claims against Bernard Ebbers and Scott Sullivan of Worldcom because, although plaintiffs showed that reports of problems reached several officers and may have been forwarded to Ebbers and Sullivan, there were no particularized allegations that Ebbers and Sullivan read the reports or discussed them with anyone. *See id.* at 251-52.

In sum, the PSLRA contains many provisions that are designed to work in tandem to eliminate frivolous litigation while allowing meritorious claims to proceed. Today, a typical securities fraud complaint is drafted after significant investigation, and it is not uncommon for plaintiffs to track down and interview former employees of the defendant corporation, as was done in this case. Even then, courts often reject allegations as insufficiently sourced. *See, e.g., Teachers' Ret. Sys. v. Hunter*, 2007 WL 509787, at *15-16 (4th Cir. 2007); *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 358 (5th Cir. 2002). Therefore, any interpretation of the scienter pleading provision must take into account the other protections against frivolous litigation, or else risk placing unrealistic burdens on plaintiffs bringing meritorious claims. *See ABC Arbitrage*, 291 F.3d at 354 (the PSLRA "was not enacted to raise the pleading burdens ... to such a level that facially valid claims, which are not brought for nuisance value or as

leverage to obtain a favorable or inflated settlement, must be routinely dismissed").

II. THE "STRONG INFERENCE" REQUIREMENT SHOULD BE GAUGED BY A "REASONABLE PERSON" STANDARD

The PSLRA requires plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). The Seventh Circuit construed this language to require that plaintiffs allege sufficient facts to permit a "reasonable person" to conclude that the defendants acted intentionally or recklessly. Pet. App. 20a; *see Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1192 (10th Cir. 2003) ("[T]he ultimate determination as to the plausibility of the competing inference offered by the defendants . . . is for the factfinder."). The Seventh Circuit's interpretation is supported both by the text of the statute and its legislative history.

A. The Plain Text of the Statute Supports the Seventh Circuit's Interpretation

"[W]here words are employed in an act which had at the time a well known meaning in the law, they are used in that sense unless the context requires the contrary." *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 115 (1939); *cf. Douglas v. Seacoast Prods., Inc.*, 431 U.S. 265, 279 (1977) (Court will "assume that Congress was aware of" the judicial interpretation of a statute it has re-enacted and "has ratified the statutory interpretation"); *Bragdon v. Abbott*, 524 U.S. 624, 645 (1998) (same). Because, at the time the PSLRA was passed, it was well-established that facts giving rise to a "strong inference of scienter" were facts sufficient to permit a reasonable jury to find that the defendants had acted with recklessness or intent, a similar construction should be given to the statutory language.

In 1979, the Second Circuit interpreted Federal Rule of Civil Procedure 9(b) to require that plaintiffs "plead those events which they assert give rise to a strong inference" that defendants acted with scienter. *Ross v A.H. Robins*, 607 F.2d 545, 558 (2d Cir. 1979); *see Beck v. Mfs. Hanover Trust Co.*, 820 F.2d

46, 50 (2d Cir.1987). This holding represented a significant tightening of the previous standards for pleading fraud under Rule 9(b), and not all circuits agreed with the Second Circuit's interpretation. *See, e.g., In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1545-47 (9th Cir. 1994) (en banc).

The Second Circuit explained that a "strong inference" meant "facts from which one can reasonably infer" scienter. *Cosmas v Hassett* 886 F.2d 8, 13 (2d Cir. 1989); *see Powers v. British Vita, P.L.C.*, 57 F.3d 176, 187 (2d Cir. 1995) (allegations sufficient "to permit a trier of fact to infer intent to defraud"); *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 271 (2d Cir. 1993) ("[W]e cannot say, on a motion to dismiss, that the plaintiffs cannot prove that a motive existed. .... Whether some focused preliminary discovery will permit the matter to be resolved adversely to the plaintiffs ... remains to be determined."); *Cohen v. Koenig*, 25 F.3d 1168, 1174 (2d Cir. 1994) ("[S]ufficient facts were pleaded to suggest that plaintiffs may be able to prove that defendants more likely than not knew that their financial representations were false."); *cf. Wexner v. First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990) (complaint insufficient because "[t]here is [] no meaningful support from which it can reasonably be inferred that" defendants had scienter); *Kramer v. Time Warner Inc.*, 937 F.2d 767, 172 (2d Cir. 1991) (no strong inference raised because "no reasonable conclusion as to state of mind may be drawn" from facts alleged).

District courts within the Second Circuit also understood the strong inference requirement to be equivalent to a "reasonable person" standard. *See, e.g., In re MTC Elec. Techs. S'holders Litig.*, 898 F. Supp. 974, 989 (E.D.N.Y. 1995); *In re Leslie Fay Cos. Sec. Litig.*, 871 F. Supp. 686, 693 (S.D.N.Y. 1995); *Drexel Burnham Lambert Group, Inc. v. Microgenesys, Inc.*, 775 F.Supp. 660, 664 (S.D.N.Y. 1991); *Furman v. Sherwood*, 833 F.Supp. 408, 416 (S.D.N.Y.1993). Even outside the Second Circuit, courts following Second Circuit law equated the "strong inference" requirement with a reasonable person standard. *See, e.g., Greenstone v. Cambex Corp.*, 975 F.2d 22, 25 (1st Cir. 1992) (plaintiffs must allege facts that "make it

reasonable to believe" defendants acted with intent; citing the Second Circuit's "strong inference" standard); *In re United Telecomm. Sec. Litig.*, 1992 WL 176430, at *1 (D. Kan. 1992).

Therefore, when the Seventh Circuit adopted a reasonable person standard in this case, it was construing the phrase "strong inference" in accord with the consistent interpretation that has been given to those words in the securities context for nearly 30 years. Because that phrase had a specific, well-defined, and agreed-upon meaning at the time of the PSLRA's passage, Congress must be assumed to have adopted that meaning when it chose to incorporate that language into the statute. *See Novak v. Kasaks*, 216 F.3d 300, 310 (2d Cir. 2000); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534 (3d Cir. 1999).

B. Legislative History Shows that Congress Adopted the Second Circuit Standard

The lack of ambiguity in the text of the statute makes resort to the legislative history unnecessary. *See West Virginia Univ. Hosps. v. Casey*, 499 U.S. 83, 98-99 (1991). However, even if one were to consult the legislative history, it is clear that Congress was both aware of and intentionally adopted the Second Circuit "strong inference" standard, believing it to be "the most stringent pleading standard" in the country. H.R. Conf. Rep. No. 369, *supra*, at 41.

i. Congress Understood the Second Circuit's Interpretation of "Strong Inference"

The "strong inference" language first appeared in S. 240, a precursor to the PSLRA. The Senate Banking Committee explained that it had adopted the Second Circuit standard to avoid creating "a new and untested pleading standard that would generate additional litigation." S. Rep. No. 104-98 at 15 (1995). Throughout various revisions, the bill retained the "strong inference" language and, in floor debates regarding the final version, several Conference Committee Managers expressed their understanding that the bill adopted the Second Circuit standard. *See* 141 Cong. Rec. S17,969, S17,959, S17,934, S17,993 (1995).

Amicus United States, reversing the position taken by the Securities and Exchange Commission ("SEC") just eight years ago when the SEC filed briefs in at least five courts of appeals arguing that Congress intended to codify the Second Circuit's standard,[2] now contends that Congress intended to raise the pleading standard above the Second Circuit's formulation. *See* U.S. Br. at 18. Specifically, Amicus relies on the following passage from the Conference Committee report:

> The Conference Committee language is based in part on the pleading standard of the Second Circuit. The standard is also specifically written to conform the language to Rule 9(b)'s notion of pleading with "particularity."
>
> . . . [T]he Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a "strong inference" of the defendant's fraudulent intent. Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard.

H.R. Conf. Rep. No. 369, *supra*, at 41. Amicus misinterprets these statements.

As explained above, in addition to requiring that securities fraud complaints create a strong inference of scienter, the PSLRA heightened the *particularity* requirements for pleading scienter. *See* 15 U.S.C. § 78u-4(b)(2). This was a significant change from even the Second Circuit's "stringent" standard, which provided that plaintiffs were obligated to provide only "a minimal factual basis for their conclusory allegations of scienter." *Connecticut*

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[2] *See* Brief of SEC, *In re Silicon Graphics, Inc. Sec. Litig.*, 195 F.3d 521 (9th Cir. 1999) (filed Nov. 1, 1997); Brief of SEC, *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542 (6th Cir. 1999) (filed Nov. 1997); Brief of SEC, *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271 (11th Cir.1999) (filed Feb. 16, 1999); Brief of SEC, *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000) (filed March 11, 1999) and Brief of SEC, *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999) (filed March 16, 1999).

Nat'l. Bank v. Fluor Corp., 808 F.2d 957, 962 (2d Cir. 1987); *see Ouaknine v. MacFarlane*, 897 F.2d 75, 79 (2d Cir. 1990) ("scienter need not be alleged with great specificity"; Rule 9(b) satisfied if plaintiff provides "some factual basis for conclusory allegations of intent"). Therefore, the Conference Report's statement that Congress intended to "strengthen" existing pleading requirements is best understood as referring to the fact that the *particularity* requirements had been enhanced. *Cf. Novak*, 216 F.3d at 310 (PSLRA adopted Second Circuit standard "with the exception of the 'with particularity' requirement"); *Advanta*, 180 F.3d at 534 (same).

Indeed, the fact that Congress chose to heighten the particularity requirements for pleading scienter while retaining the Second Circuit's "strong inference" language is further evidence that Congress endorsed the Second Circuit's "reasonable person" test. As this Court has previously held, the presumption that Congress intended to adopt an established judicial construction of particular language is especially appropriate where, as here, Congress both demonstrated its awareness of the judicial construction, and strategically *departed* from the standard language when that construction was not to its liking. *See Lorillard v. Pons*, 434 U.S. 575, 581 (1978).

ii. The History of the Specter Amendment Does Not Change the Proper Interpretation of Legislative History

Amicus New England Legal Foundation (NELF) contends that Congress's rejection of the Second Circuit's standard is evident from its refusal to adopt a particular amendment proposed by Senator Specter. Even assuming any conclusions can be drawn from the treatment of this single amendment – *see Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 187 (1994) (warning that little can be gleaned from "failed legislative proposals") – Amicus misunderstands the history behind the amendment.

After interpreting Rule 9(b) to require that complaints create a "strong inference" of scienter, the Second Circuit began to articulate

a set of standards for what sorts of facts might create the requisite inference, *see Beck*, 820 F.2d at 50, ultimately concluding that the requisite inference would be raised if plaintiffs alleged facts showing that the defendants had motive and opportunity to commit fraud, or if they alleged facts demonstrating conscious misbehavior or recklessness, *see, e.g., Acito v Imcera Group,* 47 F.3d 47, 53 (2d Cir. 1995). Thus, Senator Specter proposed an amendment to the PSLRA that would have stated that the "strong inference" test could be met through facts alleging motive and opportunity, or conscious misbehavior or recklessness. *See* 141 Cong. Rec. 17,286. The amendment was accepted by the Senate but deleted by the Conference Committee. In so doing, the Committee added a footnote to its statement about not codifying Second Circuit caselaw, writing "For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness." H. Conf. Rep. No. 369, *supra*, at 48 n.23.

Though Amicus NELF interprets the rejection of the Specter amendment to mean that Congress also rejected the Second Circuit's standard, it overlooks the obvious: As at least three circuits have recognized, it was not always certain what sorts of facts would satisfy the Second Circuit's "strong inference" threshold in the context of "motive and opportunity." *See Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 655-59 (8th Cir. 2001); *Novak*, 216 F.3d at 307; *Bryant*, 187 F.3d at 1286. It is likely for this reason that Congress hesitated to endorse Second Circuit caselaw; indeed, Senator Dodd noted the variation in Second Circuit caselaw, *see* 141 Cong. Rec. S17,960, and Senator D'Amato feared that the Specter amendment imposed *too heavy* a pleading burden on plaintiffs, *see Green Tree*, 270 F.3d at 657 n.9. However, even if Congress was uncertain what facts the Second Circuit believed sufficient to meet the "strong inference" test, nothing in the legislative history suggests that Congress intended to redefine the concept of a "strong inference" itself. *See Green Tree*, 270 F.3d at 659-60 ("The Reform Act itself adopted only the strong-inference-of-scienter standard, without codifying the particular methods

of satisfying the standard.").[3] As the First Circuit put it, "At best, there appears to have been an agreement to disagree on the issue of Second Circuit standards (other than the strong inference standard)." *Greebel*, 194 F.3d at 195.

C. The Phrase "Strong Inference" is Consistent with a "Reasonable Person" Standard

Contrary to the arguments of Petitioners and their amici, a "reasonable person" or "reasonable jury" standard is wholly compatible with the notion of a "strong" inference. Various facts may weigh in favor of a particular conclusion, but still may not reach the point where they are sufficient to support a jury verdict or to meet the party's burden of production. It is only when sufficient facts have been put forth to permit a finding in the plaintiff's favor that the inferences become "strong." *See, e.g., Anaersen v. Liberty Lobby*, 477 U.S. 242, 249 (1986) (to survive summary judgment, plaintiffs must submit evidence that is more than "colorable").

For instance, in *Greenstone*, the First Circuit sustained the dismissal of a securities fraud complaint because it failed to contain sufficient facts to "make it reasonable to believe" that the defendants had acted with scienter. 975 F.2d at 25. The court noted that one of the facts did, in fact, weigh in favor of a finding of scienter, but concluded that this single allegation was simply "not strong enough to bear the great overarching weight of factual inference the plaintiff wishes it to support." *Id.* at 27; *see Richardson by Richardson v. Richardson-Merrell, Inc.*, 857 F.2d 823, 830 (D.C. Cir. 1988) (evidence supporting plaintiffs'

[3] Amicus NELF also relies upon President Clinton's statement when vetoing the bill. NELF Br. at 10. President Clinton, relying on the Conference Report, concluded that the statute raised the pleading standard above Second Circuit levels. 141 Cong. Rec. H15214 (Dec. 20, 1995). Even if any conclusions could be drawn from such a statement, nothing in the President's statement suggests he was referring to the definition of "strong inference." Moreover, in overriding the veto, several Senators reiterated their view that the statute incorporated Second Circuit standards and that the Conference Report was not, in fact, the law itself. *See Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 169 (2d Cir. 2000); *Greebel*, 194 F.3d at 195 n.8 (citing the position of the SEC).

position not strong enough to permit jury to find in their favor). Indeed, the "reasonable person" or "reasonable jury" standard is sufficient to support liability after a full trial on the merits; it is difficult to imagine why Congress would have sought to impose a *higher* burden on plaintiffs at the pleading stage.

D. The Interpretations Offered by Petitioners and their Amici are Inconsistent with the Statutory Language and History

i. Petitioners' Interpretation is Without Support and Would Thwart Congress's Goals

Though Petitioners contend that a "strong inference" standard must go beyond a "reasonable person" formulation, they do not explain what formulation would be more appropriate. Instead, they offer various catchphrases: a complaint must "strongly show the promise or substantial merit in a plaintiff's claim of scienter," Pet. Br. at 23, or "paint a detailed picture of the facts that meaningfully tends to exclude the possibility of innocence and cogently shows that the plaintiff's claim that the defendant acted with scienter has substantial merit," Pet. Br. at 26, or present a "cogent picture of a substantially meritorious claim as to scienter," Pet. Br. at 31, or present a "cogent picture of a claim with significant merit," Pet. Br. at 30. Such standards are necessary, argue Petitioners, to effectuate Congress's goal of eliminating frivolous strike suits.

The most obvious flaw in Petitioners' argument is that they ignore the protections provided by the remaining portions of the PSLRA — several new pleading requirements, a discovery bar, new procedures for selecting lead plaintiffs, and new limitations on liability — *all* of which are geared toward eliminating frivolous actions or undue settlement pressures. Nowhere do Petitioners explain why the standard that is sufficient to support *liability at trial*, when taken in conjunction with these other measures, fails to prevent strike suits.

Indeed, it is plain that since the passage of the PSLRA, courts have stringently scrutinized complaints, demanding higher levels of detail than ever before. Securities fraud

complaints may be over 100 pages long, rely on the accounts of numerous former employees or other insiders, attach or specifically describe internal documents, or include expert analysis of data. *See, e.g., Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226 (9th Cir. 2004); *Cabletron*, 311 F.3d at 30-31; *Scholastic*, 252 F.3d at 71-73; *MCI Worldcom*, 340 F.3d at 251-52. Petitioners do not explain why increasing these already onerous burdens will eliminate *even more* frivolous actions while still permitting well-grounded claims to proceed.

If anything, the interpretation offered by Petitioners seems intentionally designed to bar legitimate claims. For instance, Petitioners repeatedly urge this Court to allow plaintiffs to proceed only if their allegations of scienter have "substantial merit." Nowhere do Petitioners explain why Congress would have wanted merely "meritorious" claims to be dismissed at the pleading stage, let alone why Congress would have chosen the simple phrase "strong inference" to communicate such an intention.

Further, Petitioners' proposed formulation is entirely without support in the legislative history, securities case law generated either before or after the PSLRA, or even in other areas of law involving motions to dismiss or summary judgment. Petitioners have simply invented a new standard out of whole cloth that literally has no basis in the entirety of American law since at least the adoption of the Federal Rules of Civil Procedure. Not only would such a brand new standard create the very havoc that Congress sought to eliminate with the PSLRA, *see Advanta*, 180 F.3d at 532, but, once again, it defies logic to think that Congress intended to impose such a novel test by employing a phrase that already had an established, judicially-defined meaning.

ii. A "Strong Inference" is Not a Preponderance

Amicus United States contends that a "strong inference" is one that leads to a "conclusion" of scienter with a "high degree of confidence." U.S. Br. at 20. Amicus argues that the inference cannot be "borderline" or a "close call," *id.* at 21, and that a strong inference is lacking if there is a "substantial possibility"

that the defendants acted innocently, *id.* at 25. Though Amicus never says so explicitly, Amicus is urging that the phrase "strong inference" be construed to mean that the judge must make his or her own subjective determination as to whether the defendants committed fraud by *at least* a preponderance of evidence, if not by something approaching a "clear and convincing" standard. *See also* Amici Grundfest et al Br. at 16 (a "strong inference" is one that is "significantly" or "substantially more likely than not to be true.").[4] Just as with the formulation offered by Petitioners, such a construction is not suggested by the text of the statute, its legislative history, or the history of securities litigation prior to the PSLRA.

Congress knows the word "preponderance" and is fully capable of using it in a statute if it so desires. *See, e.g.*, 2 U.S.C. § 1606; 5 U.S.C. § 3328; 7 U.S.C. § 499a; 8 U.S.C. § 1160; 10 U.S.C. § 920; 11 U.S.C. § 362.[5] It is not plausible that Congress, intending to create a preponderance standard – let alone a "clear and convincing" standard – did not explicitly say so, but instead chose language that had a judicially-defined meaning that was *not* preponderance and had never been used to mean preponderance ever before. Petitioners' amici do not cite a single case decided before the PSLRA in which a "strong inference" of scienter for pleading purposes was equated with a preponderance of evidence, and offer no explanation for how Congress could have expected its use of the phrase "strong inference" would be so interpreted. The only way that amici attempt to support their argument in favor of the preponderance standard is by first attempting to divine Congress's intent from the legislative history. *See* U.S. Br. at 17-18. If amici are correct, it would mean that Congress, knowing that courts only turn to legislative history if the text of a statute is ambiguous, still

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[4] Amici Grundfest et al. also contend that an "inference" means a "conclusion" reached from facts. Grundfest Br. at 16. If Congress intended "inference" to mean "conclusion," it is unclear why the word "strong" would be used to temper the word "inference."

[5] A search on Westlaw produced 194 separate appearances of the word "preponderance" in the United States Code.

nonetheless communicated its new preponderance standard solely by inserting an ambiguous sentence in the Conference Report – a sentence that, itself, does not endorse a preponderance standard.

The interpretation offered by Petitioners' amici is particularly unlikely given its extreme departure from any standard ever before employed on motions to dismiss or even on summary judgment. Judges simply do not employ "preponderance" standards unless they are making their own findings of fact – procedures that, among other things, provide both parties an opportunity for discovery and to submit evidence. If Congress intended to radically alter the judge's role in evaluating complaints and motions to dismiss, it would have employed far less oblique language.

It is also unclear what sort of precedential force these proposed determinations will have, either in future cases or in later stages of litigation. Because the sufficiency of a pleading is a legal question, *see Hunter*, 2007 WL 509787, at *3, under these amici's recommended standard, any decision on the sufficiency of a securities fraud pleading would necessarily hold, as a matter of law, that, taking the allegations in a complaint as true, there is – or there is not – a preponderance of evidence of scienter. Presumably, this would mean that if the complaint survives the motion to dismiss and the evidence ultimately matches the allegations, a jury would be constrained in its ability to disagree with the judge or, in the appropriate instance, the determinations of an appellate court. The potential for mischief in such a doctrine is enormous.

Finally, even if these amici are correct that Congress intended for the judge to conduct a personal and subjective assessment of whether the defendants committed fraud, rather than to employ an objective, reasonable person standard, there is still no reason to equate a "strong" inference with a "preponderance." There is no reason to believe that Congress only intended complaints to pass muster if, at the pleading stage, the plaintiffs already had amassed enough evidence to prove

their claims to a judge's satisfaction. Rather, a "strong" suspicion of fraud may be created even if the judge is not ready, on the pleadings, to say conclusively that the defendants acted intentionally or recklessly. To see why, it is important to remember that, generally, we presume that most companies do not commit fraud. Because fraud is relatively rare, if, on the pleadings alone, prior to discovery, there is a thirty or forty percent chance that fraud may have occurred, that is a "strong" inference, taken in context. In other words, whether allegations raise a "strong inference" of fraud must be viewed in light of the base rates of fraud. Certainly, if plaintiffs have made particularized allegations that the defendants issued materially false statements, and if plaintiffs have shown they suffered losses as a result – all pleading requirements under the PSLRA, *see Dura Pharm. v. Broudo*, 544 U.S. 336, 347 (2005); 15 U.S.C. § 78u-4(b)(1) – if they then additionally show that there is a forty percent chance that those false statements were issued intentionally or recklessly, those plaintiffs at least should be permitted access to discovery.[6] At bare minimum, plaintiffs who make such a showing have demonstrated that they are not on the sort of "fishing expedition" that the PSLRA was designed to prevent. H.R. Conf. Rep. No. 369, *supra*, at 37.

III. PETITIONERS' INTERPRETIVE PRINCIPLES ARE AT ODDS WITH THE GOALS OF THE PSLRA

Petitioners contend that the "strong inference" standard requires adherence to three "principles." These principles are both misguided and unnecessary.

A. The Complaint Should be Construed in the Light Most Favorable to Plaintiffs

For over fifty years, it has been an integral part of federal procedure that on a motion to dismiss, a court accepts all factual

[6] Even outside the securities context, the phrase "strong inference" has been used to mean less than a preponderance. *See United States v. Twenty (20) Cashier's Checks*, 897 F.2d 1567, 1570 (11th Cir. 1990) (despite strong inference to the contrary, there was no probable cause to forfeit property belonging to sisters of convicted drug trafficker).

allegations as true and construes the complaint in the light most favorable to the plaintiff. *See Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). However a "strong inference" is defined, nowhere does the PSLRA instruct judges to abandon these blackletter principles and cease to draw even *reasonable* inferences in plaintiffs' favor. Instead, the statute merely provides that although plaintiffs continue to benefit from reasonable inferences, ultimately, those inferences, taken in their totality, must create a "strong" inference. *See In re AMDOCS Ltd. Sec. Litig.*, 390 F.3d 542, 547 (8th Cir. 2004); *Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1264 (11th Cir. 2006); *Tricontinental Indus., Ltd. v. PricewaterhouseCoopers, LLP*, 475 F.3d 824, 841 (7th Cir. 2007); *Ezra Charitable Trust v. Tyco Int'l, LTD*, 466 F.3d 1, 6 (1st Cir. 2006).

Any other interpretation would further risk creating insurmountable barriers for meritorious claims. For instance, Amicus United States urges that each fact be evaluated to determine whether there exists a reasonable, and innocent, inference in addition to whatever plausible inferences exist in plaintiffs' favor, and weigh the inferences accordingly. U.S. Br. at 24. But such an approach ignores what the circuits routinely recognize: that even weak inferences, considered in their totality, can create a strong inference of wrongdoing. *See Phillips v. Scientific-Atlanta*, 374 F.3d 1015, 1017 (11th Cir. 2004); *Cabletron*, 311 F.3d at 39; *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 431 (5th Cir. 2002); *Green Tree*, 270 F.3d at 660; *Rothman v. Gregor*, 220 F.3d 81, 92 (2d Cir. 2000). And though a single fact may have innocent explanations, those innocent explanations may seem less plausible as additional facts are added to the mix. Indeed, at trial, plaintiffs would hardly be expected to prove their case by putting forth solitary pieces of evidence; they would instead expect to put on multiple pieces of evidence, which, taken together, proved their claims. *Cf. Bourjaily v. United States*, 483 U.S. 171, 179-80, (1987) ("The sum of an evidentiary presentation may well be greater than its constituent parts."). Amicus's proposed standard would,

once again, set a *higher* bar at the pleading stage than plaintiffs would be expected to meet in later stages of litigation.

Additionally, both Petitioners and their amici urge that courts draw inferences in defendants' favor when such inferences seem reasonable. Pet. Br. at 35; U.S. Br. at 24. Apparently, they would have judges act as juries: judges would be required to make their own determinations as to the most plausible explanations for each allegation, with no evidence on which to base their rulings, and no matter what reasonable disagreement might exist. Complaints would be dismissed based solely on the judge's own personal evaluations of which of several reasonable inferences was the most plausible. Once again, then, Congress's use of the phrase "strong inference" – which had been in common judicial usage since 1979 – coupled with its demand for "particularity" – language taken straight out of the federal rules – would be read by Petitioners to create a radically new system of pleading, wholly departing from established procedures as they have existed for over fifty years. Such an interpretation simply appears nowhere in the language of the statute or its legislative history.

A more plausible interpretation is that Congress intended its "strong inference" requirement to be read in conjunction with traditional notions of pleading, which, even for complaints subject to the heightened requirements of Rule 9(b), still afford plaintiffs the benefit of all reasonable inferences. *See, e.g.*, *Allwaste, Inc. v. Hecht*, 65 F.3d 1523, 1527 (9th Cir. 1995); *Kowal v. MCI Comms. Corp.*, 16 F.3d 1271, 1276 (D.C. Cir. 1994); *Schiffels v. Kemper Fin. Servs.*, 978 F.2d 344, 346 (7th Cir. 1992). No matter how the phrase "strong inference" is interpreted, it is indisputable that Congress based the statute at least in part on contemporary interpretations of Rule 9(b). *See* H. Conf. Rep. No. 369, *supra*, at 41. Congress would have expected that complaints would be evaluated as they always had been under that rule.

The danger of Petitioners' approach can be seen in the very example they use to illustrate their new standard. Petitioners

contend that facts "directly at odds" with the alleged fraudulent scheme should be interpreted to weaken inferences of scienter, and offer as an example the fact that in this case, the defendant corporation admitted to lessened demand for its products during the class period. Pet. Br. at 36. In Petitioners' view, these disclosures cannot be reconciled with a scheme to mislead the public through overstated revenue projections.

However, it should come as no great surprise that not all frauds are planned with Moriarty-like precision. *See Asher v. Baxter*, 377 F.3d 727, 728 (7th Cir. 2004) ("[T]he securities laws forbid foolish frauds along with clever ones."). It takes no leap to imagine that a company might falsely characterize the impending demand for its products in the irrational hope that it might eventually be able to turn things around. It is equally plausible that as the day of reckoning approached, the company would realize that its fraud would inevitably be disclosed, and would attempt to minimize the problem with a series of incremental disclosures. *Cf. Green Tree*, 270 F.3d at 662 (accepting allegations that defendants raced against the clock in hopes that business would turn around before the fraud could be revealed). Surely such inferences are at least plausible enough to allow the ultimate factfinder to make the final determination – with the benefit of, among other things, documentary and testimonial evidence. Perhaps more importantly, if courts were to create a blanket rule that incremental, voluntary disclosures conclusively rebut all but the most overwhelming allegations of scienter, companies would quickly learn to insulate themselves from liability, no matter how great their frauds, with an eleventh hour confession.

B. "Motives" Should Not Be Narrowly Defined

Petitioners' next "principle" is that the inferences of scienter are diminished where there is no motive for fraud. Pet. Br. at 36. As an example, they claim that in this case, plaintiffs have not alleged that Defendant Notebart personally benefited from any fraud, and have not alleged that Tellabs had a pressing need for a high stock price, such as an impending merger. Pet. Br. at 50. From this, they conclude that there was no motive at all, and that any inference of scienter is correspondingly weakened.

Id. Petitioners fail to distinguish between the absence of *any* motive, and the absence of a motive that, *in itself*, is so compelling that it contributes to an inference of scienter.

As discussed further below, courts will not draw inferences of intent or recklessness from the mere fact that a defendant might have had an "ordinary" motive to commit fraud, such as a desire to increase the corporate stock price, or, in the case of an individual, to obtain a garden-variety end-of-year bonus. Because every corporation will benefit in some way from an increased stock price and most executives receive performance-based compensation, such factors do not, without more, create an inference of fraud. *See Novak*, 216 F.3d at 307-08. However, when the stakes are unusually high – for instance, when a compensation package is particularly large – that fact can contribute to an inference of fraud. *See Green Tree*, 270 F.3d at 661.

The existence of an "ordinary" motive is not equivalent to an *absence* of motive. This Court has observed in the context of antitrust law that some alleged schemes are so economically irrational that it is highly implausible that any defendant would have engaged in them. *See Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 589-92 (1986). Even if this principle applies to securities fraud complaints, it will be a rare case when a defendant literally could not have benefited from an alleged fraud. Even mundane motives might spur fraud; it is simply that where only "mundane" motives exist, they do not contribute much to inferences of scienter. *See Green Tree*, 270 F.3d at 663-64. It does not mean that such run-of-the-mill motives actually work *against* an inference of scienter.

Moreover, it must be recalled that *Matsushita* involved allegations of an intentional, planned, years-long conspiracy, something that was particularly unlikely given the remote possibility that the defendants would ultimately profit. 475 U.S. at 590. Plaintiffs alleging securities fraud, by contrast, need only prove recklessness – and reckless actors are not necessarily known for their planning abilities and foresight. Reckless actors may gamble on being able to cover up their fraud until the economy turns around,

see Green Tree, 270 F.3d at 662; as the losses mount, bigger gambles may be required to continue to conceal the wrongding, *see* Donald C. Langevoort, *Agency Law Inside the Corporation*, 71 U. Cin. L. Rev. 1187, 1218 (2003). Reckless actors may bow to personal pressures. *See AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 205 (2d Cir. 2000). Some of the most infamous frauds in recent years may have resulted from corporations that encouraged and cultivated climates of excessive recklessness and risk taking. *See* Lynn E. Dallas, *A Preliminary Inquiry into the Responsibility of Corporations and their Officers and Directors for Corporate Climate: The Psychology of Enron's Demise*, 35 Rutgers L.J. 1, 45-51 (2003).

In this case, plaintiffs may not have alleged the existence of a motive so extraordinary that, by itself, it contributes to an inference of scienter, but the alleged scheme is not economically irrational in the *Matsushita* sense. Tellabs and its employees would have reaped the benefits associated with a higher stock price, and it is plausible that defendants might have recklessly sought to mislead the market about current demand in hopes that the underlying reality would catch up to their public optimism. "Although these contentions do not amount to a showing of an unusual, heightened motive . . . , they at least paint a rational and plausible picture" of why the defendants might have undertaken the fraud. *Green Tree*, 270 F.3d at 665.

Indeed, the very fact that Petitioners offer this argument – that they contend that the absence of "heightened" motive for fraud should actually weigh in their favor – highlights the danger of counseling courts to choose among competing reasonable inferences.

C. There Can Be No Blanket Rule Regarding the Treatment of Inferences in Equipoise

i. Precedent Developed in the Antitrust Context is Inapplicable

In an ordinary motion to dismiss or for summary judgment, reasonable inferences must be drawn in favor of the nonmoving party. *See Liberty Lobby*, 477 U.S. at 255; *Ezra Charitable*

Trust, 466 F.3d at 5-6. If there is ambiguity in the proper interpretation of evidence, the case goes forward. *See Douglas v. York County*, 360 F.3d 286, 290 (1st Cir. 2004). Petitioners, however, relying almost entirely on two antitrust cases decided on summary judgment, argue that when allegations are "equally consistent with innocence as they are with culpability," there can be no strong inference of scienter. Pet. Br. at 37. These cases are unique to antitrust law and should not be applied here.

In *Matsushita* and *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752 (1984), this Court held that in antitrust actions, plaintiffs cannot meet their burden of production by alleging "conduct as consistent with permissible competition as with illegal conspiracy." *Matsushita*, 475 U.S. at 588. But nothing in *Matsushita* supercedes the ordinary principle that reasonable inferences are to be drawn in favor of the nonmoving party even at the summary judgment stage – let alone on a motion to dismiss. This is because although it is indisputable as a matter of logic that when a fact is truly "equally" consistent with legal behavior and with illegal behavior, it cannot be said to weigh in either party's favor, it is difficult to determine when that point has been reached. *See* Note, *Summary Judgment and Circumstantial Evidence*, 40 Stan. L. Rev. 491, 504 (1988). Ordinarily, there may be a reasonable range of opinions as to whether the particular fact is, truly, "equally" consistent with both parties' contentions. When a jury may reasonably believe that the fact is actually more consistent with one party's version of events than another's, the case must go forward, even if the judge believes that the evidence is in equipoise. *See id.*

Antitrust laws, however, are designed to foster competition, and the line between legal, competitive behavior and illegal, anticompetitive behavior is generally drawn based on economic theory. *See generally* Phillip E. Areeda and Herbert Hovenkamp, 1 *Antitrust Law: An Analysis of Antitrust Principles and their Application* (2006). That is, in the antitrust context, behavior crosses into illegality when there has been a determination (either for a class of cases, or under a "rule of reason" analysis) that

the behavior is more likely to do economic harm than good. *See Texaco Inc. v. Dagher*, 126 S. Ct. 1276, 1279 (2006). In *Matsushita* and *Monsanto*, this Court was particularly sensitive to such concerns, noting that just about any conduct that fell short of actually violating the antitrust laws was not only not prohibited, but might, in fact, be precisely the kind of healthy competitive behavior that Congress sought to protect. *See Matsushita*, 475 U.S. at 594; *Monsanto*, 465 U.S. at 761-63. In this context, the precise facts on which the plaintiffs relied to prove the existence of a conspiracy were not only not illegal, but actually *beneficial* behaviors – particularly in the case of *Matsushita*, where the essence of the conspiracy alleged was to *lower* prices. In such a situation, the Court – as a matter of public policy – was unwilling to risk deterring pro-competitive behavior by allowing a jury to rely on the very beneficial conduct that the laws were designed to protect as evidence of illegality. *See Matsushita*, 475 U.S. at 588 ("[A]ntitrust law limits the range of permissible inferences from ambiguous evidence in a § 1 case."). Additionally, in the case of *Matsushita*, this Court believed that various economic aspects of the scheme made it extremely implausible, further heightening the need for additional evidence. *See Matsushita*, 475 U.S. at 589-92.

The securities laws are different. Although Congress wished to encourage companies to make various voluntary disclosures, the line between legal conduct (truthful disclosures), and illegal conduct (untruthful disclosures) is not based on an economic policy judgment in the same way that antitrust lines are drawn. Additionally, the types of facts upon which plaintiffs typically rely to support an inference of scienter are not the *statements themselves* (i.e., the conduct Congress wished to encourage), but are other sorts of facts – such as reports that problems were common knowledge within the company, *see City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 684-87 (6th Cir. 2005), the existence of profits from insider trading, *see Scholastic*, 252 F.3d at 74-75, or accounting violations of extreme magnitude, *In re Daou Sys.*, 411 F.3d 1006, 1022 (9th Cir. 2005). These behaviors may not be *illegal* when undertaken

without fraudulent intent, but neither has Congress gauged them beneficial or sought to encourage them. Therefore, there is no reason to set a general rule that the determination as to *when* evidence *is in fact* in equipoise must be taken out of the hands of the jury, let alone taken out of the jury's hands at the pleading stage, before discovery.

To be sure, in some specific situations, the banality of the conduct alleged may be so plain that there can be no reasonable disagreement even as to the probabilities themselves. That is, there may be specific types of situations where there is no room for any disagreement as to whether the conduct is equally consistent with innocent as with culpable conduct. Courts have recgonized this principle for years, well before the passage of the PSLRA, and have developed a variety of tools for recognizing the presence of such allegations and refusing to allow them to contribute to an inference of scienter.

For instance, in developing its "motive and opportunity" test, the Second Circuit eventually settled on the principle that inferences of scienter could not be drawn from motives "possessed by virtually all corporate insiders" such as "the desire to maintain a high stock price in order to increase executive compensation." *Novak*, 216 F.3d at 307; *see also Green Tree*, 270 F.3d at 655-57 (explaining the evolution of the Second Circuit's test). This principle has been uniformly followed by other circuits, *see, e.g., Kushner v. Beverly Enters., Inc.*, 317 F.3d 820, 829 (8th Cir. 2003); *Cabletron*, 311 F.3d at 39; *GSC Partners CDO Fund v. Washington*, 368 F.3d 228, 237 (3d Cir. 2004); *Ottman*, 353 F.3d at 352, because it is indisputable that most, if not all, corporate executives stand to benefit economically from an increase in their company's stock price. Similarly, scienter cannot be inferred from an auditing firm's desire to earn fees. *See, e.g., Tricontinental*, 475 F.3d at 841. However, if the plaintiff shows that there was something unusual about a particular compensation package that takes it out of the norm, that fact may at least contribute to the scienter inquiry. *See, e.g., Green Tree*, 270 F.3d at 661.

All courts agree that a defendant's sales of stock prior to disclosure of unfavorable information will not support an inference of scienter unless the plaintiff alleges specific facts demonstrating that the sales were unusual in magnitude or timing. *See, e.g., In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256 (3d Cir. 2006). These courts reason that executives sell stock for a variety of reasons, including imminent departure from the company, *see, e.g., In re K-Tel Int'l, Inc. Sec. Litig.*, 300 F.3d 881, 896 (8th Cir. 2002), or simply because they sell on a regular basis, *in re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1423 (3d Cir. 1997). Once again, because there can be no disagreement as to the banality of stock sales by corporate executives, no reasonable factfinder could rely solely on such sales to infer scienter.

Several other similar rules have been agreed upon by all of the circuits,[7] with the caveat that such allegations will contribute to the inference of scienter when there is something unusual about the situation that takes it out of the realm of ordinary corporate conduct. *See, e.g., Scholastic*, 252 F.3d at 77; *Daou*, 411 F.3d at 1022; *Advanta*, 180 F.3d at 539. But, as should be evident from these examples, there can be no general, across-the-board rule that facts as likely to be associated with legal conduct as with illegal conduct shall be disregarded. Leaving aside the obvious point that an apparently innocent fact may seem less so when considered in conjunction with other facts, *see Phillips*, 374 F.3d at 1017, it is only in the context of particular types of allegations that a court can even begin to evaluate whether, in fact, there can even be reasonable disagreement over these antecedent probabilities.

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[7] For example, courts will not presume fraud from the existence of accounting violations alone, *e.g., DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 390 (9th Cir. 2002), or presume knowledge from corporate title, *e.g., Suprema Specialties*, 438 F.3d at 282, or infer fraud solely from the fact that a corporation experienced losses after making optimistic statements, *e.g., DiLeo v. Ernst & Young*, 901 F.2d 624, 627-28 (7th Cir. 1990).

ii. The PSLRA Does Not Replace the Principle that a Plaintiff is Master of His Complaint

Extrapolating from their two antitrust summary judgment decisions, Petitioners rely on pleading precedents issued nearly 100 years before the adoption of the Federal Rules of Civil Procedure to argue that plaintiffs should be required to plead in their complaint even facts adverse to their allegations. Pet. Br. at 38-39.[8] As an example of the type of "improper" pleading that Petitioners seek to eliminate, they point to plaintiffs' allegations that a report unfavorable to Tellabs was generated in early 2001. Pet. Br. at 46. Relying in part on the existence of this report, the Seventh Circuit drew the inference Defendant Notebart was aware of certain unfavorable facts prior to making contrary public statements in February 2001. Petitioners argue that because a report alleged to have issued in "early 2001" may have been completed after Notebart spoke in February – in which case no inference of fraud can be drawn – plaintiffs should not be permitted to "strategically" delete the precise date of the report. *See id.*

First, as a general matter, even if the report issued after Notebart spoke, that does not mean that no inference can be drawn. Tellabs had commissioned the report and presumably cooperated with its authors as it was being prepared; Tellabs employees may well have been privy to the report's conclusions prior to its formal completion. *Cf. Greenstone*, 975 F.2d at 26 (knowledge of legal problems may be inferred when a lawsuit follows in close proximity to an allegedly false statement). If such were the case, the inferences of knowledge might be weakened, but would not entirely disappear.

Leaving this point aside, as no formal discovery has yet occurred, Petitioners do not explain why they believe the date of the report is in plaintiffs' possession, and offer no suggestions for how a court is to distinguish "strategic" ambiguity from plaintiffs' own lack of complete knowledge. Petitioners do not explain why Rule 11 would not be sufficient to deter plaintiffs

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[8] It should be noted that even Amicus United States disagrees with Petitioners' position. U.S. Br. at 25.

from actively seeking a court to accept inferences that the plaintiffs know, for a fact, to be untrue. *Cf. Green Tree*, 270 F.3d at 668. Finally, Petitioners do not explain how plaintiffs themselves are to determine, at the drafting stage, what is improper "strategic" ambiguity and what is simply the ordinary exercise of their privilege to draft their complaints so as to present their claims in the best possible light. Once again, Petitioners would have this Court conclude that by incorporating language with a pre-existing legal meaning into a new statute, Congress sought a drastic reworking of the Federal Rules of Civil Procedure in a manner that has never been contemplated by any modern court.

IV. THE PSLRA SHOULD BE INTERPRETED WITH AN UNDERSTANDING OF THE VITAL ROLE PLAYED BY PRIVATE SECURITIES LITIGATION IN OUR REGULATORY SYSTEM

Private litigation is a "necessary supplement" to public enforcement of the securities laws. *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964). According to the congressional testimony of then-SEC Chairman Arthur Levitt, "Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws." *Common Sense Legal Reform Act: Hearing Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Commerce*, 104th Cong. 2 (1995) (prepared statement). In the wake of recent accounting scandals in 2001 and 2002, Congress reiterated the importance of private securities actions when enacting the Sarbanes-Oxley Act of 2002 which, among other reforms, extended the statute of limitations for securities fraud cases. *See* Pub. L. No. 107-204, Title VIII, § 804(a)(b) and (c).

Private enforcement is necessary because the SEC simply does not have the resources to police the entire market. For instance, last year, the number of enforcement cases brought by the agency declined 9% as the agency grappled with staffing cuts and a budget crunch. *See* Carrie Johnson, *SEC Enforcement Actions Decline 9%*, Wash. Post, Nov. 3, 2006, at D3. Private

actions often yield larger recoveries for defrauded investors than SEC enforcement suits. For instance, the SEC's Enron-related settlement fund holds approximately $440 million; the private actions, in contrast, have achieved a recovery of more than $7.3 billion. *Compare* http://www.sec.gov/divisions/enforce/claims/enron.htm *with* http://www.universityofcalifornia.edu/news/2006/sep21a.html (last visited 3/5/2007). The SEC recovered $750 million for Worldcom investors, while the private litigation recovered over $6 billion. *Compare* http://www.worldcomvictimstrust.com *with* http://www.worldcomlitigation.com/html/citisettlement.html (last visited 3/5/07). And in the pending Global Crossing class action, investors have already recovered $444 million; the SEC, by contrast, has not recovered any monies for investors. As Amicus United States concedes, "[M]eritorious private actions are an essential supplement to criminal prosecutions and civil enforcements." U.S. Br. at 1.

The PSLRA has also largely accomplished Congress's goal of eliminating frivolous litigation. Since its passage, dismissals on the pleadings have nearly doubled. *See* NERA Economic Consulting, *Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar*, at 4 (Jan. 2007). The number of filings has declined as well: In 2006, securities fraud lawsuits fell to a record low. *See* Cornerstone Research, *Securities Class Action Case Filings – 2006: A Year in Review*, at 1 (Jan. 2007). Professor James D. Cox at Duke Law School studied 600 securities class actions filed since the passage of the PSLRA and opined that in the wake of the new rules, it was difficult to find any that were abusive or malicious. *See* Stephen Labaton, *Businesses seek new protection on legal front*, N.Y. Times, Oct. 29, 2006, at A1.

Moreover, since the passage of the PSLRA, more institutional investors – public pension funds in particular — have taken on lead roles, precisely as Congress envisioned. *See* Stephen J. Choi, Jill E. Fisch and A.C. Pritchard, *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private*

Securities Litigation Reform Act, 83 Wash. U.L.Q. 869-905 (2005). These investors, such as Amici, not only play a pivotal gatekeeping role in weeding out strike suits, but they also demand corporate governance reforms in addition to monetary recoveries as part of their settlements. *See generally* Michael Perino, *Institutional Activism through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions,* St. John's Univ. School of Law, Legal Studies Research Paper Series, Paper #06-0055 (Oct. 2006)(avail. at http://ssrn.com/abstract=938722); *see also In re Cendant Corp. Litig.*, 264 F.3d 201, 246-47 (3d Cir. 2001) (approving such a settlement). The presence of institutional investors leads to larger recoveries and lower attorneys' fees, exactly as Congress predicted. *See generally* Perino, *supra*. In short, with the PSLRA, Congress accomplished exactly what it set out to do. Frivolous lawsuits have been reduced or eliminated; institutional investors have taken control of shareholder litigation, and investors have benefited as a result. If pleading standards are heightened further, as Petitioners demand, all that will result is that more meritorious actions – the kind that Congress intended to preserve as a crucial aspect of our regulatory system – will be barred at the courthouse door.

CONCLUSION

The Seventh Circuit's "reasonable person" standard for determining whether a complaint creates a "strong inference" of scienter comports with the consistent interpretation that had been given to those words for 25 years prior to the passage of the PSLRA. The alternative standards offered by Petitioners and their amici not only represent a wholesale departure from existing precedent, but would place onerous burdens on plaintiffs bringing legitimate claims. For these reasons, the Seventh Circuit's decision should be affirmed.

Respectfully submitted,

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Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD C. NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF OF TECHNET, THE INFORMATION TECHNOLOGY ASSOCIATION OF AMERICA, THE SEMICONDUCTOR INDUSTRY ASSOCIATION, AEA, BAYBIO, THE CALIFORNIA HEALTHCARE INSTITUTE AND THE NATIONAL VENTURE CAPITAL ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICI CURIAE*[1]

Technology Network ("TechNet") is a network of Chief Executive Officers and senior partners of more than 150 companies in the information technology, biotechnology, venture capital, investment banking and legal industries, representing the heart of the global innovation economy. The association is chartered to promote the growth of the technology industry and the economy. The majority of TechNet's members lead companies that are publicly traded on the NYSE or the NASDAQ. Other members invest in promising new ventures, some of which grow to become industry leaders in their own right. As members and investors in the high technology and biotechnology industries, TechNet's members represent the leading edge of developing, manufacturing, and marketing emerging technologies. The technology industry ranks among the most vibrant sectors in the economy, and provides both a key engine of job creation and a spectrum of new products that improve the lives of people across the nation and the world.

Since 1977, the Semiconductor Industry Association ("SIA") has been a leading voice for the $115 billion U.S. semiconductor industry. Semiconductors are the enabling technology for the information age, and are a key component in everything from computers and cell phones to video games and satellites. Moreover, semiconductor companies are key participants in the global innovation economy, and many semiconductor companies reinvest a quarter of their revenue in research and development and capital expenditures. The U.S. leads the world in semiconductor technology, capturing 46% of the fiercely competitive world market.

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[1] Both parties have consented to the submission of this brief in letters filed with the Clerk. No counsel for a party authored this brief in whole or in part, and no person or entity other than *amici* and their counsel made a monetary contribution to its preparation or submission.

There are 234,000 people employed in the semiconductor industry in the U.S. The SIA unites all of the nation's major semiconductor companies, who are collectively responsible for more than 85% of semiconductor production in America. The SIA further shapes public policy on issues critical to the industry and provides a spectrum of services to aid members in growing their own businesses.

The Information Technology Association of America (ITAA) provides global public policy, business networking, and national leadership to promote the continued rapid growth of the IT industry. ITAA consists of approximately 325 members throughout the U.S., and is secretariat of the World Information Technology and Services Alliance, a global network of 67 countries' IT associations. ITAA plays a leading role in issues of IT industry concern including information security, taxes and finance policy, digital intellectual property protection, telecommunications competition, workforce and education, immigration, online privacy and consumer protection, government IT procurement, human resources and e-commerce policy. ITAA members range from the smallest IT start-ups to industry leaders in the Internet, software, IT services, digital content, systems integration, telecommunications, and enterprise solution fields.

AeA (formerly the American Electronics Association) is the largest association of high-tech companies in the United States with about 2,500 companies, representing all segments of the technology industry and 1.8 million employees. As a nationwide non-profit trade association, AeA provides a broad range of services in the business and public policy arenas to member companies active in the software, medical device, telecommunications, instrumentation, computer, semiconductor, aerospace, defense, and manufacturing sectors. Founded in 1943, AeA now has eighteen offices across the U.S., as well as offices in Europe and Asia.

The National Venture Capital Association (NVCA) is a trade association that represents the U.S. venture capital industry. It is a member-based organization, which consists of venture capital firms that manage pools of risk equity capital designated to be invested in high growth companies. NVCA's mission is to foster greater understanding of the importance of venture capital to the U.S. economy, and support entrepreneurial activity and innovation. The NVCA represents the public policy interests of the venture capital community, strives to maintain high professional standards, provides reliable industry data, sponsors professional development, and facilitates interaction among its members.

BayBio is an independent, non-profit trade association serving the life science industry in Northern California. BayBio represents more than 350 member organizations engaged in or supportive of the development of life sciences products. BayBio provides these services through representatives in South San Francisco and through coalition partners in Sacramento and Washington, DC. Through advocacy, membership services, programs and more, BayBio brings the world's largest life science community together.

The California Healthcare Institute ("CHI") is a non-profit, public policy research and advocacy organization for California's biomedical industry. Founded in 1993, CHI has more than 200 members, including California's leading biotechnology, medical device and pharmaceutical companies, as well as the state's premier universities and private research institutions. CHI's mission is to advance responsible public policies that promote scientific discovery and foster medical innovation. CHI conducts economic and public policy research, produces industry analyses, develops educational programs, formulates policy, serves as a clearinghouse for information about California's biomedical industry, and

engages in direct advocacy on behalf of the biomedical R&D enterprise and the patient community it serves.

The question presented by this case—the standard for pleading a "strong inference" of fraudulent intent in securities cases governed by the Private Securities Litigation Reform Act of 1995 (the "Reform Act")—is an issue of great importance to *amici*, and to the entire technology community. The Reform Act was calculated to allow valid fraud claims to proceed while blocking "the routine filing of lawsuits against issuers of securities . . . whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer." H.R. Rep. No. 104-369, at 31 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730. Because technology stock prices are often highly volatile, as the market potential of emerging technologies fluctuates, technology companies have been frequent targets of abusive securities suits. *See, e.g.*, 141 Cong. Rec. H2763 (1995) (statement of Rep. Cox) ("High-tech and biotech companies have paid 40 percent of the costs of strike suit settlements . . . ."). Even in the post-Reform Act era, companies in the technology industries remain the target of over 40% of all private securities litigation. Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. Ill. L. Rev. 913, 959. The securities cases before this Court illustrate the frequent targeting of technology companies; both this case and the recent suit against Dura Pharmaceuticals involve information technology or biotechnology companies. *See, e.g., Dura Pharms., Inc. v. Broudo*, 544 U.S. 336 (2005).

In light of the continual litigation against technology companies, it is vital to *amici*, and to the innovation economy itself, that the Reform Act's protections be stringently enforced. As one of the key constituencies that the Reform Act was intended to protect, as well as one of the principal

beneficiaries of a healthy capital market structure, the technology community has a unique perspective on the proper balance between safeguards against litigation abuses and measures to preserve valid claims. The "strong inference" requirement forms a critical part of that balance, which must be fully implemented if the Reform Act is to serve its intended purpose. *Amici* therefore respectfully submit this brief in support of Petitioners.

STATEMENT

Congress passed the Reform Act in response to widespread abuses in securities litigation. Following extensive hearings, Congress found that while meritorious suits may promote "public and global confidence in our capital markets" and help deter wrongdoing, "significant evidence" indicated that these benefits were being "undermined" by frequent meritless suits. H.R. Rep. No. 104-369, at 31 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730. Abuses Congress identified included (1) the routine filing of "cookie cutter" complaints following every stock drop, without regard to an issuer's culpability and with only a "faint hope" that later discovery might produce a "plausible" claim; (2) the targeting of "deep pocket defendants" solely for settlement value; and (3) discovery practices designed to impose "massive costs," making it more economical for defendants to settle than to litigate.[2] H.R. Rep. No. 104-369, at

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[2] These abuses have "turned out to be a special danger to new companies, particularly high-technology ventures with volatile stock prices. The Country has a strong interest in encouraging these companies and shielding them from a style of legal assault that is not far from extortion." 141 Cong. Rec. S19146-47 (1995) (statement of Sen. D'Amato) (quoting Editorial, *Override the Securities Bill Veto*, Washington Post, Dec. 22, 1995, at A18); *see also* 141 Cong. Rec. E184 (1995) (statement of Rep. Mineta) (litigation costs "result in less capital for the R&D investments U.S. high-tech companies use to maintain their position at the cutting edge of the world market. For these reasons, securities litigation reform is a top priority for our Nation's high technology community.").

31-32 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730-31; S. Rep. No. 104-98, at 16 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 680, 695. Congress found that as a result of these practices, "innocent parties are often forced to pay exorbitant 'settlements'" with the result that "the issuer's own investors . . . are the ultimate losers." H.R. Rep. No. 104-369, at 32. Congress further concluded that "fear that inaccurate projections will trigger the filing of securities class action lawsuit [sic] has muzzled corporate management," denying investors crucial information. *Id.* at 43. The House Report concluded that through such practices, "the class action device was being used to injure 'the entire U.S. economy.' H.R. Rep. No. 104-369, p. 31 (1995)," *quoted in Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1510 (2006).

Prompted by these findings, a bipartisan Congress enacted "uniform and more stringent pleading requirements" for securities cases. H.R. Rep. No. 104-369, at 41 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 740. These heightened standards, as set forth in the Reform Act, require that a "complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). More importantly for present purposes, the Reform Act also requires that any securities complaint:

> state with particularity *facts* giving rise to a *strong inference* that the defendant acted with the required state of mind.

15 U.S.C. § 78u-4(b)(2) (emphasis added). In addition, the Reform Act creates a "safe harbor" against liability for com-

panies that disclose valuable forward-looking information. 15 U.S.C. § 78u-5(c). The Reform Act further bars discovery until a complaint is determined to meet the Act's rigorous pleading standards. 15 U.S.C. § 78u-4(b)(3). In so doing, the Reform Act allows properly supported claims to proceed, while screening out improper suits prior to discovery, thus protecting innocent parties from the burdens that had previously been used to force unmerited settlements. *See, e.g.,* H.R. Rep. No. 104-369, at 31-32; S. Rep. No. 104-98, at 16.

As a result of these changes, cases governed by the Reform Act are treated differently than other federal court civil litigation, where notice pleading under the Federal Rules of Civil Procedure suffices. *Ronconi v. Larkin*, 253 F.3d 423, 437 (9th Cir. 2001) (Reform Act effects "an unusual deviation from the usually lenient requirements of federal rules pleading."). The Reform Act expressly requires a securities plaintiff to identify specific facts in order to withstand a motion to dismiss. In most other settings, plaintiffs receive the benefit of all favorable inferences at the pleading stage. Not so under the Reform Act: the allegations must, when taken as a whole, support a *strong* inference of wrongdoing, and cannot stand merely because some rational inference exists that favors plaintiffs. *See, e.g., Gompper v. VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002). Accordingly, while facts alleged with specificity are still taken as true at the pleading stage, *see id.* at 896, the Reform Act thus "alters the normal operation of inferences under Fed. R. Civ. P. 12(b)(6)." *In re Digital Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 28 (1st Cir. 2002) (same).

Despite the Reform Act's pronouncement of a uniform scienter standard against which allegations should be measured, courts have differed sharply in their application of that

standard. *See* Pet. at 17-25. The Ninth Circuit has recognized that consideration of a "strong inference" necessarily entails evaluating "all reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs." *VISX, Inc.*, 298 F.3d at 897. Under this standard, which the First, Fourth, and Sixth Circuits have paralleled, a complaint supports a "strong inference" of scienter only where fraud is the most likely inference on the facts alleged. *See, e.g., id.* (citing *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (en banc), *cert. dismissed*, 536 U.S. 935 (2002) ("plaintiffs are entitled only to the most plausible of competing inferences"). Other Circuits, however, have declined to apply this rigorous test. The Tenth and Eighth Circuits, for instance, have refused to weigh competing inferences at the pleading stage. *See, e.g., Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1188 (10th Cir. 2003). The Second Circuit has not directly addressed the issue, but has continued to apply its pre-Reform Act scienter standard (which the Third Circuit has also adopted). *See, e.g., Novak v. Kasaks*, 216 F.3d 300, 310 (2d Cir. 2000); *In re Advanta Corp.*, 180 F.3d 525, 534-35 (3d Cir. 1999). Most recently, the Seventh Circuit held in the case at bar that a strong inference arises on "facts from which, if true, a reasonable person *could infer* that the defendant acted" with scienter. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602 (7th Cir. 2006) (emphasis added). These conflicting standards, and particularly the Seventh Circuit's approach, have prevented the protections Congress created from being fully realized.[3]

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[3] Litigation patterns have shifted in response. In the Ninth Circuit, once the most common securities venue, the percentage of suits filed there has declined. *See, e.g.*, Perino, 2003 U. Ill. L. Rev. at 916 (noting "statistically significant" decline in Ninth Circuit filings). In parallel, the Second Circuit—until *Tellabs*, the most plaintiff-friendly post-Reform Act venue—has become the most common forum for such suits. *See, e.g.*, Cornerstone Research, *2006: A Year in Review*, at 15, *available at* http://securities.stanford.edu/clearinghouse_research/2006_YIR/20070102-01.pdf. (Second Circuit had the most filings in 2005 and 2006). This

SUMMARY OF ARGUMENT

To preserve valid claims while combating "significant abuses" in securities cases, the Reform Act requires, among other things, that facts alleged with particularity support a "strong inference" of scienter. 15 U.S.C. § 78u-4(b)(2). This plain language compels reversal here. An inference of fraud is not "strong" if it is less plausible than other inferences arising from the same facts. A court can only determine whether an inference is "strong" by evaluating "all reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs," and allowing cases to proceed to the costly discovery phase only where particularized facts support fraud as the most plausible scenario. *VISX*, 298 F.3d at 897. Any lesser standard is flatly inconsistent with the text Congress has chosen, and with the Reform Act's purpose of screening out improper claims at an early stage.

The legislative history confirms that Congress intended to bar suits at the pleading stage where the facts alleged do not strongly suggest fraud. Congress passed the Reform Act precisely because Fed. R. Civ. P. 9(b) had not prevented highly speculative complaints from reaching the discovery stage. The Reform Act expressly elevates the pleading standard above Rule 9(b), and beyond the standards imposed by prior law. Standards that allow securities fraud suits to proceed on inferences that, compared to others available, are implausible, would not accomplish that goal, and would effectively revive the pre-Reform Act regime.

The "strong inference" requirement embodies a careful balance between the goals of protecting against litigation abuses and allowing valid claims to proceed. This balance

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correlation between suit frequency and pleading standard laxity highlights the continued existence of abuse.

requires that courts consider all logical inferences from particularized facts, and allow cases to proceed only where (at the very least) fraud is a more plausible inference than innocence. The decision below failed to effectuate that balance, and thus should be reversed.

ARGUMENT

I. THE PLAIN LANGUAGE OF THE REFORM ACT'S "STRONG INFERENCE" REQUIREMENT COMPELS REJECTION OF THE SEVENTH CIRCUIT'S STANDARD.

The aim of the Reform Act is to more reliably screen out frivolous securities class actions and prevent them from imposing burdens on the American economy. It accomplishes this by requiring, *inter alia*, that plaintiffs allege particularized facts supporting their claims, and that those facts support a "strong inference" of scienter. 15 U.S.C. §78u-4(b). By providing the standard that the required detailed facts must satisfy, the "strong inference" component of the Reform Act forms an indispensable part of this mechanism.

The plain text of the statute requires more than "a permissible inference" or a "reasonable inference." It requires a "strong inference." 15 U.S.C. § 78u-4(b)(2); *VISX*, 298 F.3d at 897 (rejecting inference that is "reasonable and warranted"). A "strong inference" by definition must be more than the "reasonable" inferences that allowed securities plaintiffs to proceed prior to the Reform Act. *See, e.g., In re Read-Rite Corp. Sec. Litig.*, 335 F.3d 843, 848-49 (9th Cir. 2003) (rejecting claims even to the extent facts supported "reasonable" inference of fraud); *In re VISX, Inc. Sec. Litig.*, Nos. C 00-0649 CRB, C-00-0815 CM, 2001 WL 210481 at *3 (N.D. Cal. 2001) (Breyer, J.) ("[S]trong must mean something more than merely 'reasonable.'").

"'Strong inferences' . . . involve deductive reasoning; their strength depends on how closely a conclusion of misconduct follows from a plaintiff's proposition of fact." *Helwig*, 251 F.3d at 553. To evaluate the strength of the connection between facts and a conclusion of fraud that plaintiffs seek to draw from those facts, a court necessarily must review the entirety of the permissible inferences and determine, at a bare minimum, that an inference of fraud is more plausible than those suggesting innocence. *See, e.g., VISX*, 298 F.3d at 897. An inference of fraud cannot be "strong" if the most likely scenario on the facts alleged, and the conclusion that flows most closely from those facts, is non-fraudulent conduct. *See, e.g., id.* (rejecting claims where fraud was less likely than unsuspicious inference). Nor is an inference of fraud "strong" "when, viewed in light of the complaint as a whole, there are legitimate explanations for the behavior that are equally convincing." *In re Credit Suisse First Boston Corp. Analyst Reports Sec. Litig.*, 431 F.3d 36, 49 (1st Cir. 2005); *see also e.g. Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 350 (4th Cir. 2003) ("Strong inference" did not exist where negligence was as likely as fraud). Accordingly, as a logical matter, a complaint supports a "strong" inference of scienter only where deliberate fraud is the more likely scenario flowing from the facts alleged—as four Circuits have recognized. *Credit Suisse*, 431 F.3d at 49; *Ottman*, 353 F.3d at 350; *Helwig*, 251 F.3d at 553; *VISX*, 298 F.3d at 896-97.

The structure of the Reform Act confirms this reading of the "strong inference" provision. *See, e.g., Exxon Mobil Corp. v. Allapattah Servs.*, 125 S. Ct. 2611, 2620 (2005) (to determine what Congress enacted, court "must examine the statute's text in light of context, structure, and related statutory provisions"). The Reform Act's discovery stay, its command that plaintiffs supply "all facts" supporting their

claims, and its "strong inference" requirement combine to serve a carefully balanced gatekeeping function. *See* 15 U.S.C. §§ 78u-4(b)(1), (2), (3). Together, these provisions allow claims to proceed only where they are founded on particularized allegations showing a strong likelihood of fraud, while preventing speculative claims from being used to support potentially abusive discovery. The purpose of this screening mechanism would be defeated if Congress's language were interpreted to allow plaintiffs to impose discovery burdens based upon fraud inferences that are barely plausible. *See, e.g., VISX*, 298 F.3d at 896-97 ("Congress made it crystal clear that the [Reform Act]'s pleading requirements were put in place so that only complaints with particularized facts giving rise to a strong inference of wrongdoing survive a motion to dismiss . . . .")

The Seventh Circuit's formulation of the standard is impossible to reconcile with the text and structure of the Reform Act. The Seventh Circuit's command that plaintiffs supply "facts from which, if true, a reasonable person could infer that the defendant acted with the required intent," *see Tellabs*, 437 F.3d at 602, effectively applies the pre-Reform Act approach of sustaining claims when any reasonable inference of fraud could support a suit. *See, e.g., In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 270 (2d Cir. 1993) (drawing all inferences in plaintiffs' favor), *superseded by statute as stated in Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir. 1999). Several other circuits, including the Tenth and Eighth, have similarly declined to weigh competing inferences, and have invoked pre-Reform Act 12(b) jurisprudence in support of a lenient standard. *See, e.g., Novell*, 339 F.3d at 1188 (continuing to draw inferences in plaintiffs' favor based in part on application of traditional 12(b)(6) standard). These approaches are incorrect on multiple grounds. Setting aside the Reform Act's alteration of the framework for pleading challenges, *see supra* at 5, these

constructions "eviscerate the PSLRA's strong inference requirement by allowing plaintiffs to plead in a vacuum." *VISX*, 298 F.3d at 896; *see also, e.g., Credit Suisse*, 431 F.3d at 51 (courts should not "turn a blind eye to the universe of possible conclusions stemming from a given fact or set of facts"). Under these standards, plaintiffs do not even need to supply the full range of particularized facts the Reform Act demands, because they can use improbable but technically possible inferences to fill any gaps in their factual allegations. These approaches invite the illogical conclusion that a "strong inference" does not mean "strong," as the text states, but merely "not impossible." By accepting "reasonable" inferences uncritically, the standard set forth by the Seventh Circuit, and other similarly lenient standards, effectively read the "strong inference" language out of the statute, in direct contravention of "cardinal principle[s] of statutory construction." *Bennett v. Spear*, 520 U.S. 154, 173 (1997) (Court will "give effect, if possible, to every clause and word of a statute") (citations omitted).

Where the facts alleged with particularity show alternate inferences to be as or more likely than fraud, the plaintiff has not satisfied its pleading burden of demonstrating a "strong inference" of securities fraud. The rigorous application of the "strong inference" requirement enables early rejection of claims based on speculative inferences, *see, e.g., VISX*, 298 F.3d 893, while facilitating claims founded on strong inferences drawn from particularized facts. Any more lenient construction would fail to effectuate the Reform Act as written. Given the Reform Act's gatekeeping function, there is no basis for interpreting its "strong inference" requirement to permit plaintiffs to impose discovery burdens where the most plausible inferences are inconsistent with fraud. This Court therefore should reverse the decision below.

II. THE LEGISLATIVE HISTORY CONFIRMS CONGRESSIONAL INTENT TO SCREEN OUT BARELY PLAUSIBLE CLAIMS OF SECURITIES FRAUD

The legislative history confirms what the Reform Act's language compels: that Congress intended to heighten the standard for pleading scienter. Even the Seventh Circuit recognizes that the Reform Act "did unequivocally raise the bar for pleading scienter." *Tellabs*, 437 F.3d at 601.

Congress enacted the Reform Act precisely because Federal Rule of Civil Procedure 9(b) "ha[d] not prevented abuse of the securities laws by private litigants." H. R. Rep. No. 104-369, at 41 (1995) (Conf. Rep.) *as reprinted in* 1995 U.S.C.C.A.N. 730, 740 (quoted in *In re Comshare Inc. Sec. Litig.*, 183 F.3d 542, 548 (6th Cir. 1999)). Congress recognized "a need" to establish "more stringent pleading requirements" to restrict securities suits to meritorious claims, and "to curtail the filing of meritless lawsuits." *Id.* To fulfill that need, Congress expressly elevated the pleading standard beyond Rule 9(b), and beyond anything in existing law. *See* Message to the House of Representatives Returning Without Approval the "Private Securities Litigation Reform Act of 1995," 31 Weekly Comp. Pres. Doc. 2210 (Dec. 19, 1995).

To craft a new and more stringent standard, Congress began with the then-strictest scienter requirement in the nation, which was the Second Circuit's "strong inference" approach. It then went a step further, cautioning that "[b]ecause [it] intend[ed] to strengthen existing pleading requirements, it [did] not intend to codify the Second Circuit's case law interpreting [the "strong inference"] pleading standard." *See* H.R. Rep. No. 104-369, at 41, 48 n.23 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 740, 747. Indeed, while the Senate precursor to the final statute

adopted a full version of the Second Circuit's interpretation of the "strong inference" requirement in substance, the Conference Committee deliberately removed that language to more expressly raise the Reform Act's pleading standard above that established in Second Circuit decisions. *See* H.R. Rep. No. 104-369, at 48 n.23 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 747. The Conference Committee confirmed its decision to adopt a higher standard in its final report, noting Congress's choice "not to include . . . language relating to motive, opportunity, or recklessness" as set forth in Second Circuit opinions. *Id.*

President Clinton recognized the intention to make pleading standards more rigorous than those in force in the Second Circuit in his message to Congress vetoing the Reform Act. *See* Message to the House of Representatives Returning Without Approval the "Private Securities Litigation Reform Act of 1995," 31 Weekly Comp. Pres. Doc. 2210 (Dec. 19, 1995). He indicated that, while he was willing to support a codification of the Second Circuit's pleading standard, it was "crystal clear" that the Reform Act was intended "to raise the pleading standard even beyond that level." *Id.* Congress overrode that veto, and passed the Reform Act—a direct mandate to implement the stringent pleading standard President Clinton and the Conference Committee described.

The Seventh Circuit's standard is impossible to reconcile with this compelling evidence of Congressional intent to enhance scienter pleading standards beyond existing law. *See VISX*, 298 F.3d 893. As noted, the Seventh Circuit's approach, by affording plaintiffs the benefit of all permissible inferences, is no different than the regime that prevailed prior to the Reform Act. *See supra* at 9. Such a construction is thus improper, as are the standards of other Circuits that apply pre-Reform Act law. *See, e.g., Novak v. Kasaks*, 216

F.3d 300, 310 (2d Cir. 2000); *In re Advanta Corp.*, 180 F.3d 524, 534-35 (3d Cir. 1999).[4]

III. THE REFORM ACT'S STRICT PLEADING STANDARD COMPORTS FULLY WITH THE CONSTITUTION

Perhaps recognizing the disconnect between its standard for reviewing securities fraud pleadings and Congress's express intent that federal courts play a more active gatekeeping role, the Seventh Circuit suggests that a stringent construction of "strong inference" might implicate jury trial rights under the Seventh Amendment. *See, e.g., Tellabs*, 437 F.3d at 602. This concern is misplaced. There is nothing unusual or problematic about requiring district courts to enforce a stringent pleading standard of the sort set forth in the Reform Act.

Judges routinely make decisions that either impact or terminate litigation without jury input. Motions to dismiss, motions for summary judgment, *see* Fed. R. Civ. P. 56, and motions for judgment as a matter of law, *see id.* at Rule 50, are all determined by judges without (and in some cases, despite) jury findings. And as a general matter, crucial—even

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[4] The *Novak* and *Advanta* decisions, which applied the prior Second Circuit scienter standard, based their reasoning on the presence of the term "strong inference" in earlier Second Circuit opinions, and on other comments within the legislative history. *See, e.g., Novak*, 216 F.3d at 311-12. The reasoning of these courts, however, is inconsistent with Congress's rejection of proposals designed simply to codify the Second Circuit's test, with compelling legislative history that the Reform Act did not simply adopt the Second Circuit test, and with the Clinton veto message. The use of the "strong inference" language and surrounding commentary simply shows that Congress found the then-existing highest standard instructive in its attempt to craft a new, even more rigorous standard. In light of the overwhelming evidence suggesting that Congress created a standard higher than the Second Circuit's approach, continued application of pre-Reform Act standards is improper.

dispositive—evidentiary rulings, in criminal as well as civil actions, are made by judges. *See, e.g.*, Fed. R. Evid. 104 (providing for court to determine questions of admissibility), 403 (allowing court to exclude evidence where the risk of undue prejudice outweighs the probative value of the evidence). Such gatekeeping mechanisms are fundamental parts of our judicial system.

It is thus not surprising that judicial enforcement of pleading and other procedural requirements of the kind at issue here have long been held to have no impact on jury trial rights. *See, e.g., Baltimore & Carolina Line, Inc. v. Redman*, 295 U.S. 654, 657 (1935). Every heightened pleading standard is by definition intended to ensure that only selected allegations are permitted to reach a jury for factfinding. Challenges based on a plaintiff's inability to satisfy congressionally-imposed (or even judge-made) pleading standards do not implicate jury trial rights, as "the issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims." *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974), *overruled on other grounds, Harlow v. Fitzgerald*, 457 U.S. 800 (1982). Elevated pleading standards are deeply rooted features of existing law. *See, e.g., Swierkiewicz v. Sorema, N.A.*, 534 U.S. 506, 512-13 (2002) (identifying example of heightened pleading requirements under Rule 9(b)).

Congress unquestionably has the power to create (and modify) the substantive standards for securities fraud claims, just as in other areas of federal law. With this power comes the concomitant power to impose heightened pleading standards. *See, e.g., Jones v. Bock*, ___ S.Ct. ___, Nos. 05-7058, 05-7142, 2007 WL 135890 at *9-10 (Jan. 22, 2007) (recognizing that Congress possessed, but had not exercised, the power to create specific pleading requirement of exhaustion of remedies). What Congress has done here can be analo-

gized to the judge-made rule that permits certain antitrust claimants to get to a jury only if their proffered evidence "tend[s] to exclude the possibility" that the defendants' conduct resulted from independent decision making. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.* 475 U.S. 574, 597 (1986) (internal quotation omitted). By preventing such antitrust plaintiffs from proceeding with claims where the evidence is equally consistent with lawful and unlawful behavior, this rule helps prevent antitrust litigation from chilling independent, and pro-competitive, behavior. *See id.* Similarly, Congress here has required securities plaintiffs to identify specific facts that make an inference of scienter more probable than competing inferences before proceeding in order to prevent speculative fraud claims from imposing burdens on behavior (such as good-faith forward-looking projections) that Congress wishes to encourage.

While there is, of course, a continuum of possible standards, there is no inherent constitutional difficulty with standards at the stringent end of the spectrum. If facts alleged are insufficient to state a claim according to the standard Congress selects, the case ends without any role for a jury or any offense to jury trial rights. Indeed, Rule 9(b) itself reflects that structure: while it compels rejection of cases that satisfy Rule 8's notice pleading standard, it has never been held to offend constitutional principles in doing so. *See, e.g., Swierkiewicz*, 534 U.S. at 513 (recognizing 9(b)'s heightened standard).

The "strong inference" requirement that Congress has imposed here is thus no less defensible than other legislatively- or judicially-established pleading or evidentiary rules. The Reform Act simply requires that to state a cause of action for securities fraud, plaintiffs must allege facts that meet a particularized pleading standard. To be sure, Congress has selected a stringent standard, given the evidence of historical

abuse of the securities class action vehicle. Nevertheless, there is no principled reason why the stringency of this standard (which no Circuit has held to violate due process rights) would cause it to be any less constitutionally sound than other heightened pleading standards.[5]

IV. THE FACTS OF THIS CASE DEMONSTRATE THE NEED FOR STRINGENT APPLICATION OF THE REFORM ACT

"The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud." *See, e.g., DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990) (dismissing case). Specifically, plaintiffs charge Tellabs' management with making falsely optimistic statements while knowing that Tellabs would not meet expectations. *See Tellabs*, 437 F.3d at 592-593. Yet the complaint lacks allegations placing knowledge of an upcoming miss in the mind of any defendant. With the benefit of hindsight, plaintiffs allege that the CEO overstated demand, and that internal reports existed that identified the demand decline that ultimately came to pass. *See id.* at 603. Plaintiffs do not show that the CEO knew of those reports when he spoke, however. The Seventh Circuit even acknowledges that he may not have known of the decline when he spoke. *Id.* ("[I]t is conceivable that [the CEO] had yet to see the reports suggesting his company was in trouble"). The opinion simply discounts that point on the grounds that "a reasonable person could infer" that the CEO knew of the reports. *Id.* at 602. Accordingly, this case is at its core a common accusation of

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[5] Congress's power to set a standard it deems proper is particularly broad given that the Section 10(b) cause of action itself, as an implied right of action under a federal statute, exists only due to Congressional acquiescence. *See* 15 U.S.C. § 78u-4.

"fraud by hindsight," with no remarkable features in terms of either theory or supporting fact.

"Congress's basic purpose in raising the bar in the first place" was "to put an end to the practice of pleading fraud by hindsight" in this manner. *VISX*, 298 F.3d at 897. While virtually every company falls short of expectations at some point during its history, disappointment does not equate to fraud. Even before the Reform Act, "[i]nvestors seeking relief under Rule 10b-5 ha[d] to distinguish their situation from that of many others who are adversely affected by business reverses." *DiLeo*, 901 F.2d at 627. In the post-Reform Act era, without specific facts showing that fraud in fact occurred, there is "no way of distinguishing [plaintiffs'] allegations from the countless 'fishing expeditions' which the [Reform Act] was designed to deter." *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 988 (9th Cir. 1999) (dismissing claims).[6] Yet plaintiffs allege no such facts here. Because this case lacks facts that place knowledge of an imminent miss in the mind of the CEO, it falls squarely within the category of strike suits the Reform Act targets.

This case runs afoul of the Reform Act in an additional respect in that it rests on exactly the kind of forward-looking information that Congress sought to encourage companies to disclose without fear of liability. Congress found that "a company's own assessment of its future potential would be among the most valuable information shareholders and potential investors could have about a firm." H.R. Rep. No.

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[6] Unsupported assertions that warnings in internal reports alerted executives to an imminent miss similarly do not distinguish strike suits from instances of fraud. "[E]very sophisticated corporation uses some kind of internal reporting system reflecting earlier forecasts; allowing [plaintiffs] to go forward with a case based on general allegations of 'negative internal reports' would expose all those companies to securities litigation whenever their stock prices dropped." *Silicon Graphics*, 183 F.3d at 988 (citations and quotations omitted).

104-369, at 43 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 742. Congress concluded, however, that issuers were declining to provide such information for fear that a failure to meet forecasts would result in a lawsuit. *Id.* The Reform Act was therefore calculated "to enhance market efficiency by encouraging companies to disclose forward-looking information" without fear of open-ended liability in the event that forward-looking statements proved less than prophetic. *See id.* This suit, which criticizes Tellabs for inaccurate forecasting, would create just the kind of disincentive to forthright discussions of future prospects that Congress feared. The "strong inference" requirement, and its ban on suits lacking compelling evidence of fraud, is part of a carefully crafted plan to prevent such an outcome. For the purposes of the Reform Act to be realized, that screening mechanism must be applied according to its terms.

Because this case constitutes exactly the kind of hindsight criticism of forward-looking discussions that Congress enacted the Reform Act to prevent, the consequences of allowing this suit to proceed are impossible to overstate. If the Reform Act were found not to block such suits—despite Congress's clear intent to do so—companies would be effectively returned to the pre-Reform Act regime with all of its attendant abuses. Accordingly, if the goals of Congress are to be achieved, the "strong inference" requirement must be given its due force, and the allegations here must fail.

This is not to say that the Reform Act is so stringent as to bar all claims. As Congress has concluded, anti-fraud protections serve a vital role in maintaining the integrity of the capital markets on which the technology community depends. *See supra* at 2. The Reform Act therefore does not present a barrier to suits where adequate indicia of fraud exist. Even in Circuits that have strictly applied the Reform Act's strong inference requirement, complaints can and do

withstand motions to dismiss. The Reform Act is calculated simply to ensure that the crucial anti-fraud mechanisms of the Securities Exchange Act of 1934 are reserved for non-speculative claims of fraud.

CONCLUSION

It is vitally important for *amici*, for the innovation economy, and for the capital markets themselves, that the Reform Act be implemented as Congress intended. The judgment of the Court of Appeals should be reversed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

TELLABS, INCORPORATED and RICHARD NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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INTEREST OF THE *AMICUS CURIAE*[1]

The Washington Legal Foundation ("WLF") is a non-profit public interest law and policy center based in Washington, D.C., with supporters in all 50 states. WLF devotes a substantial portion of its resources to defending and promoting free enterprise, individual rights, and a limited and accountable government. To that end, WLF has appeared before this Court and other federal and state courts as *amicus curiae* in numerous cases raising issues relating to the proper scope of the federal securities laws. *See, e.g., Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336 (2005); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S.Ct. 1503 (2006); *In re Stock Exchanges Options Trading Antitrust Litig.*, 317 F.3d 134 (2d Cir. 2003). WLF has no financial interest in the outcome of this case.

The questions presented here – including the proper interpretation of Congress's heightened pleading requirements in the Private Securities Litigation Reform Act of 1995 – involve legal issues of fundamental importance to the financial industry, investors, and the national economy. WLF has a vital interest in ensuring that the uniform standards adopted by Congress to curb abuse of the federal securities laws are not undermined by the adoption of an interpretation that effectively nullifies the heightened standards Congress enacted. WLF is concerned that if the Seventh Circuit's decision below is not reversed, opportunistic plaintiff attorneys will continue to abuse the litigation process, contrary to Congress's express decision to

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[1] Letters from the parties consenting to the filing of this brief have been lodged with the Clerk of the Court. Pursuant to this Court's Rule 37.6, *amicus* states that no counsel for any party authored this brief, in whole or in part, and that no entity or person, aside from *amicus* and its counsel, made any monetary contribution to the preparation or submission of this brief.

raise the pleading requirements for federal securities lawsuits. Such a result would likely interfere with the efficient functioning of the United States economy. As *amicus curiae*, WLF believes that the arguments set forth in this brief will assist the Court in determining and resolving the issues presented in this appeal.

SUMMARY OF ARGUMENT

For important policy reasons, Congress in the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 747 ("PSLRA"), adopted a heightened and strict pleading standard by mandating that federal securities fraud complaints must "state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind." 15 U.S.C. § 78u-4(b)(2). The Seventh Circuit, in reversing the district court's order dismissing the complaint in this action, adopted an incorrect interpretation of the PSLRA's pleading standard that serves to undermine the very purpose of the statutory enactment.

Under this Court's authorities, Congress's "strong inference" pleading standard in the PSLRA should be interpreted in accordance with the plain and ordinary meaning of the words employed. But the Seventh Circuit erroneously interpreted the phrase "strong inference" to mean that a motion to dismiss should be denied if any "reasonable" inference of scienter could be drawn from the complaint's allegations. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 601-03 (7th Cir. 2006). The Seventh Circuit adopted this startlingly weak construction in order to evade what it viewed to be a possible constitutional question with respect to the plaintiff's Seventh Amendment right to jury trial. *Id.* at 601-02. This was error and, in fact, the PSLRA's pleading standard raises no genuine constitutional issues under this Court's Seventh Amendment jurisprudence.

Congress plainly has the authority to establish the rules that govern federal statutory causes of action, and to direct the dismissal of complaints by federal courts as legally inadequate where Congress's chosen standards have not been met. Indeed, this Court has recognized Congress's clear authority to set or elevate the governing standards for the very securities fraud claims at issue here. *See Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 748-49 (1975).

The Seventh Amendment has never been interpreted to prevent Congress from establishing legal standards and pleading rules that, if not satisfied by plaintiffs, require dismissal by the court and thereby preclude the plaintiff from getting to a jury. Rather, as the Court has held, the Seventh Amendment preserves "'the basic institution of jury trial in only its most fundamental elements[.]'" *Parklane Hosiery Co., Inc. v. Shore*, 439 U.S. 322, 336-37 (1979) (quoting *Galloway v. United States*, 319 U.S. 372, 392 (1943)). The Seventh Amendment does not preserve, or otherwise constrain, "'the great mass of procedural forms and details'" by which the courts control litigation and regulate the jury's role on questions of fact, *id.*, including the application of new rules that may lead to the termination of litigation and prevent a party from ever reaching a jury. *See also Fidelity & Deposit Co. of Maryland v. United States*, 187 U.S. 315, 320 (1902); *Ex parte Peterson*, 253 U.S. 300, 309-10 (1920); *Galloway*, 319 U.S. at 389-91.

The PSLRA's heightened pleading requirements and accompanying motion to dismiss, 15 U.S.C. §§ 78u-4(b)(1), 4(b)(2), 4(b)(3)(A), effectively alter and amend Federal Rules of Civil Procedure 8(a), 9(b), and 12(b)(6), as applied to certain federal securities claims. Nothing in the Seventh Amendment ties Congress or the courts either "to the common-law system of pleading," *Galloway*, 319 U.S. at 390, or to any particular pleading rules in the Federal Rules of

Civil Procedure or otherwise, *see also Fidelity & Deposit Co. of Maryland*, 187 U.S. at 319-21. Properly understood, Congress in the PSLRA has merely established the legal rules and standards that private securities fraud plaintiffs must satisfy in their complaints – as a matter of law – before they may seek discovery and, in appropriate cases, present a securities fraud claim to a jury for its "ultimate determination." *Ex parte Peterson*, 253 U.S. at 310. When granting a motion to dismiss for failure to comply with Congress's heightened pleading standards in the PSLRA, courts are making the sort of threshold legal determinations that do not impinge upon any jury-trial rights preserved by the Seventh Amendment.

Once the Seventh Amendment underbrush is cleared, it is apparent that the Seventh Circuit woefully misinterpreted the PSLRA's "strong inference" standard. Consistent with the plain meaning of the words employed by Congress, a "strong inference" of scienter is *not* merely any "reasonable" inference that "could" be drawn. *Makor Issues & Rights, Ltd.*, 437 F.3d at 602. Rather, to survive a motion to dismiss under the PSLRA, the complaint's particularly pled facts must collectively give rise to an inference of scienter that is "both reasonable and 'strong'[.]" *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 196 (1st Cir. 1999).

While reversing the Seventh Circuit here, the Court should adopt an interpretation of the PSLRA's heightened pleading standard that directs courts to assess whether the totality of a securities fraud complaint's well-pleaded particularized facts, when assumed to be true, give rise to a sufficiently strong inference of scienter. *See, e.g., Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1187 (10th Cir. 2003). In making that determination, courts should be directed to consider all possible inferences that arise from the well-pleaded particularized facts, including both ones favorable and unfavorable to plaintiff's ultimate allegation that the

defendant acted with the requisite scienter. *Id.*; *Gompper v. VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002); *accord*, *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2005); *Ottman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345, 350 (4th Cir. 2003); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001).

Consistent with standards this Court has adopted elsewhere, no sufficiently "strong" inference of scienter should exist as a matter of law if there is merely an attenuated, weak, indirect or speculative connection between the complaint's well-pleaded particularized facts and the defendant's having acted with the requisite scienter,[2] and unless the complaint's particularly pled scienter allegations tend to exclude the defendant's having acted with a non-culpable mental state.[3]

For the reasons set forth further below, the Court should reverse on the ground that the Seventh Circuit applied an incorrect legal standard, and remand for further proceedings consistent with the Court's opinion.

ARGUMENT

I. CONGRESS ENACTED THE PSLRA'S HEIGHTENED PLEADING REQUIREMENTS FOR POLICY REASONS TO PREVENT AND DETER MERITLESS SECURITIES FRAUD LITIGATION

Congress in the PSLRA enacted a series of provisions designed to curb serious "perceived abuses" of the federal securities laws in actions brought pursuant to Section 10(b) of

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[2] *Cf.*, *Associated General Contractors of California Inc. v. California State Council of Carpenters*, 459 U.S. 519, 535-46 (1983).

[3] *Cf.*, *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 588 (1986).

the Securities Exchange Act of 1934 and Rule 10b-5. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S.Ct. 1503, 1510 (2006); *see also* H.R. Rep. No. 104-369, at 31 (1995) (Conf. Rep.) (noting "significant evidence of abuse in private securities lawsuits," including "routine filing of lawsuits ... whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of [the defendants]," and "abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized [defendants] to settle"), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730.

This Court has long recognized the potential for private litigant abuse of the federal securities laws, *see, e.g.*, *Blue Chip Stamps*, 421 U.S. at 739-41; *Dabit*, 126 S.Ct. at 1510, and Congress in the PSLRA determined that the *actuality* of such abuses warranted remedial legislation.

In an "effort to deter or at least quickly dispose of those suits whose nuisance value outweighs their merits," Congress placed "special burdens" on plaintiffs seeking to bring federal securities fraud actions. *Dabit*, 126 S.Ct. at 1511.

In particular, Congress "impose[d] heightened pleading requirements" on private securities fraud plaintiffs. *Id.* These include not only the requirement that "securities fraud complaints 'specify' each misleading statement" and "set forth the facts 'on which [a] belief' that a statement is misleading was 'formed'," but also the demand that such complaints must "'state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.'" *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 345 (2005) (quoting 15 U.S.C. §§ 78u-4(b)(1), (2)); *accord*, *Dabit*, 126 S.Ct. at 1511.[4]

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[4] As this Court has held, scienter – the "intent to deceive, manipulate, or defraud" – is an essential element to any private securities fraud damages claim. *Ernst & Ernst v. Hochfelder*, 425

In addition, Congress in the PSLRA explicitly provided for a "motion to dismiss" premised upon any "failure to meet" the "pleading requirements" of 15 U.S.C. §§ 78u-4(b)(1) and (b)(2), and therein directed that the "court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met." 15 U.S.C. § 78u-4(b)(3)(A). Congress further directed that "all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party." 15 U.S.C. § 78u-4(b)(3)(B).

Prior to the PSLRA, federal securities fraud complaints were adjudged under Federal Rule of Civil Procedure 9(b), which states: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."

For policy reasons, Congress determined that the general pleading requirements of the Federal Rules of Civil Procedure had proven inadequate to prevent "abuse of the securities laws by private litigants." H.R. Rep. No. 104-369, at 41, *as reprinted in* 1995 U.S.C.C.A.N. at 740; *accord*, *Dabit*, 126 S.Ct. at 1510. Congress altered the operation of those rules only with respect to federal securities fraud claims by enacting 15 U.S.C. § 78u-4(b).

As relevant here, the PSLRA's heightened pleading standard has two core components. First, Congress extended Rule 9(b)'s particularity pleading requirement to the issue of scienter, mandating that "with respect to each act or omission" alleged to violate the federal securities laws, the

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U.S. 185, 193 (1976). Given the securities fraud claims in this case, that is the "required state of mind" referenced in the PSLRA's heightened pleading standard under 15 U.S.C. § 78u-4(b)(2).

complaint must state "facts" concerning the defendant's allegedly culpable mental state "with particularity." 15 U.S.C. § 78u-4(b)(2).

Second, Congress elevated the legal standard governing what circumstantial factual allegations may be considered sufficient to allege the defendant's requisite scienter, by insisting that the complaint's particularly pled facts must "giv[e] rise to a *strong inference* that the defendant acted with the required state of mind." *Id.* (emphasis added). As several courts have noted, the PSLRA alters that aspect of the ordinary practice on motions to dismiss under Rule 12(b)(6) which previously may have given plaintiffs the benefit of any "reasonable" inference that might be drawn from the complaint's well-pleaded factual allegations. *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195-96 (1st Cir. 1999); *see also In re Digital Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004); *Gompper v. VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002); *Florida State Bd. of Admin. v. Green Tree Financial*, 270 F.3d 645, 660 (8th Cir. 2001); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001). Congress altered this practice with respect to inferences at the pleading stage, as applied to motions to dismiss under the PSLRA including the "motion to dismiss" explicitly recognized under 15 U.S.C. § 78u-4(b)(3)(A).

There can be no doubt that, as a general proposition, Congress has the authority to enact legislation that heightens pleading standards beyond those otherwise applicable under the Federal Rules of Civil Procedure.[5] Although federal courts may "not by judicial interpretation" heighten pleading standards for particular claims, this Court has acknowledged

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[5] Indeed, Congress indisputably has the general power and constitutional authority to establish and amend the "rules governing the practice and pleading in th[e federal] courts." *Hanna v. Plumer*, 380 U.S. 460, 472 (1965).

the authority of *Congress* to do so. *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 515 (2002) ("requirement of greater specificity for particular claims is a result that 'must be obtained by the process of amending the Federal Rules'") (quoting *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 168 (1993)).

It is equally clear that Congress has the authority to amend and strengthen the legal standards and pleading rules by which private federal securities fraud complaints are measured and adjudged – just as Congress has the authority to alter and heighten the "standard of proof" applicable to such claims. *Huddleston*, 459 U.S. at 389 (judicially prescribing standard of proof for private Section 10(b) securities fraud claims where "Congress has not prescribed the appropriate standard"); *see also Blue Chip Stamps*, 421 U.S. at 748-49 ("if Congress had legislated" particular requirements to govern the private implied right of action judicially found to exist under section 10(b) and Rule 10b-5, "the duty of the Judicial Branch would be to administer the law which Congress enacted").

This is precisely what Congress has done in the PSLRA. It has amended the law to establish heightened pleading standards applicable to certain private actions under the federal securities laws, and explicitly directed courts to dismiss complaints at the pleading stage when those standards have not been met. Consequently, it is the duty of the Judicial Branch to administer the law which Congress has enacted.

II. THE PSLRA'S PLEADING STANDARD SHOULD BE INTERPRETED IN ACCORDANCE WITH THE PLAIN AND ORDINARY MEANING OF THE WORDS EMPLOYED BY CONGRESS

At the core of this Court's resolution of the split among the Circuits with respect to the PSLRA lies the proper

interpretation of the "strong inference" standard under 15 U.S.C. § 78u-4(b)(2).

The Court should construe the operative phrase "strong inference" in accordance with the plain and ordinary meaning of the words employed, just as it would the language used in any other statute. *See, e.g., BP Am. Prod. Co. v. Burton*, 127 S.Ct. 638, 643 (2006) ("Unless otherwise defined, statutory terms are generally interpreted in accordance with their ordinary meaning."); *S. D. Warren Co. v. Me. Bd. of Envtl. Prot.*, 126 S.Ct. 1843, 1846 (2006) (because statutory term "discharge" in Section 401 of the Clean Water Act is "neither defined in the statute nor a term of art," it must be construed "in accordance with its ordinary or natural meaning"); *Aaron v. S.E.C.*, 446 U.S. 680, 700 (1980) ("In the absence of a conflict between reasonably plain meaning and legislative history, the words of the statute must prevail.").

Indeed, the Court should interpret the PSLRA's pleading requirements in accordance with the plain meaning of the statutory terms employed just as the Court has repeatedly interpreted the language employed in the Federal Rules of Civil Procedure in accordance with their "plain meaning." *Business Guides, Inc. v. Chromatic Communications Enters., Inc.*, 498 U.S. 533, 540 (1991); *Pavelic & LeFlore v. Marvel Entertainment Group*, 493 U.S. 120, 123 (1989).

The plain and ordinary meaning of "inference" is not disputed. Leading dictionaries define the word to mean "the act of passing from one or more propositions . . . considered as true to another the truth of which is believed to follow from that of the former," WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1158 (2002); and the "act or process of deriving logical conclusions from premises known or assumed to be true." AMERICAN HERITAGE COLLEGE DICTIONARY 710 (4th ed. 2004); *accord*, BLACK'S LAW DICTIONARY 778 (6th ed. 1990) ("inference" defined as meaning the "process of reasoning by which a fact or proposition sought to be

established is deduced as a logical consequence from other facts, or a state of facts, already proved or admitted").

Further, the plain and ordinary meaning of the word "strong" includes "powerful," "forceful and pointed," "persuasive, effective, and cogent," "intense in degree or quality," and "readily detected or received." AMERICAN HERITAGE COLLEGE DICTIONARY, at 1369; WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY, at 2265 (further defining "strong" as including "striking or superior of its kind," "having a particular quality in great degree," "well established," "firmly fixed," and "not easily altered or eradicated"); *see also* BLACK'S LAW DICTIONARY, at 1423 (defining "strong" as "cogent, powerful, forcible, forceful").[6]

Interpreting the PSLRA's "strong inference" standard in accordance with the plain and ordinary meaning of the words employed is consistent with the purpose of this statutory amendment. Both the Senate Report and House Conference Report indicate that Congress chose the PSLRA's scienter pleading standard, derived in part from the Second Circuit's standard, because it was regarded as "the most stringent pleading standard." S. Rep. No. 104-98, at 15 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 694; H.R. Rep. No. 104-369, at 41, *as reprinted in* 1995 U.S.C.C.A.N. at 740; *see also Florida State Bd. of Admin.*, 270 F.3d at 656-57. Yet Congress elected to adopt only the language of the standard (*i.e.*, "strong inference"), and did "not intend to codify the

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[6] The ordinary and plain meaning of the word "weak" inversely corresponds to the definition of "strong." *See, e.g.*, AMERICAN HERITAGE COLLEGE DICTIONARY 1552 (4th ed. 2004) (defining "weak" as "[l]acking physical strength, energy, or vigor; feeble"; "Likely to fail under pressure, stress, or strain"; "Lacking firmness of character or strength of will"; "Lacking the proper strength or amount of ingredients"; "Lacking persuasiveness; unconvincing"; and "Lacking potency or intensity").

Second Circuit's caselaw interpreting this pleading standard, although courts may find this body of law instructive." S. Rep. No. 104-98, at 15, *as reprinted in* 1995 U.S.C.C.A.N. at 694.[7] Hence, Congress left it to the courts, and ultimately this Court, to interpret the content of the PSLRA's "strong inference" standard as a matter of statutory construction.

When Congress's "strong inference" standard is assessed in accordance with the plain and ordinary meaning of the words employed, there can be no question that the Seventh Circuit's construction does violence to the statutory text. Indeed, the Seventh Circuit interpreted the PSLRA's "strong inference" standard in a manner that read the critical word "strong" out of the statute, and effectively replaced it with the word "reasonable." *See Makor Issues & Rights, Ltd.*, 437 F.3d at 601-03. According to the Seventh Circuit, the proper interpretation of the PSLRA's "strong inference" standard is one that "will allow the complaint to survive if it alleges facts from which, if true, a *reasonable person could infer* that the defendant acted with the required intent." *Id.* at 602 (emphasis added). It is only when *no* reasonable person possibly could draw *any inference* that the defendant acted with scienter that – under the Seventh Circuit's erroneous interpretation – a motion to dismiss may be granted under the PSLRA on the ground that the complaint fails as a matter of law to meet the requirements of 15 U.S.C. § 78u-4(b)(2). *Id.*

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[7] Those circuit courts that have canvassed the PSLRA's legislative history in an effort to divine the proper interpretation of the strong inference standard have concluded that it is ultimately "ambiguous and even contradictory" on that question, *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 411 (5th Cir. 2001); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 531 (3d Cir. 1999), and does not provide any clear indication of congressional intent, *Florida State Bd. of Admin.*, 270 F.3d at 656-58.

The Seventh Circuit's holding in this respect is wrong as a matter of statutory construction. A "strong inference" of scienter, 15 U.S.C. § 78u-4(b)(2), is not merely any *reasonable* inference that could be drawn, and nothing in the statutory text or legislative history remotely supports the Seventh Circuit's construction to that effect. Under the PSLRA, "inferences of scienter survive a motion to dismiss only if they are both reasonable and 'strong' inferences." *Greebel*, 194 F.3d at 195-96; *accord*, *Florida State Bd. of Admin.*, 270 F.3d at 660. The construction adopted by the Seventh Circuit reduces the standard back down to the ordinary pleading interpretive rules that Congress explicitly heightened by adopting the PSLRA's "strong inference" standard, which defeats the very purpose of the statutory amendment.

In determining whether an inference of scienter is sufficiently "strong," courts must engage in deductive reasoning to assess the *relationship* between a complaint's particularly pled facts and the ultimate allegation that defendant acted with the requisite scienter, which is an essential element to the claim. *See Ernst & Ernst*, 425 U.S. at 193. The relationship must be sufficiently close and proximate, and sufficiently forceful and striking, to constitute the sort of "strong inference" of scienter that Congress has required to survive a motion to dismiss. *Cf.*, *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1422-24 (3d Cir. 1997) (Alito, J.). If, in the totality of the complaint's particularly pled factual allegations, this process of deductive reasoning reveals only a weak and attenuated connection, then a motion to dismiss should be granted as a matter of law. Consistent with the plain meaning of the textual phrase "strong inference" in 15 U.S.C. § 78u-4(b)(2), the complaint's particularized allegations with respect to the defendant's mental state – when taken together and assumed to be true – must rationally provide a powerful, cogent, and forceful basis

upon which to conclude that the defendant acted with the requisite intent to deceive or scienter. *See supra* pp. 10-11.

The stated reason why the Seventh Circuit adopted its strikingly relaxed construction of the PSLRA's "strong inference" standard was to avoid any possible Seventh Amendment issue from arising. *See* 437 F.3d at 601-03. But this analysis cannot withstand scrutiny. Specifically, the Seventh Circuit identified the possibility that some interpretations of the "strong inference" requirement "could potentially infringe upon plaintiffs' Seventh Amendment rights." *Id.* at 602 (citing *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004)). But after identifying the issue, the Court of Appeals "express[ed] no view" on whether any interpretation "is in fact unconstitutional" and, indeed, engaged in no constitutional analysis at all. *Id.* Instead, the panel of the Seventh Circuit elected to adopt a construction of the PSLRA's strong inference standard "that cannot be misunderstood as a usurpation of the jury's role." *Id.* In effect, the Seventh Circuit adopted its strained interpretation of the words employed by Congress to *save* the statute from a theoretical and hypothesized constitutional infirmity that was not argued by plaintiffs to exist, and not even determined by the Seventh Circuit to exist. However, as detailed further below, Congress's heightened pleading standard in the PSLRA does not implicate any genuine constitutional issues under this Court's Seventh Amendment jurisprudence.

III. THE PSLRA'S PLEADING STANDARD DOES NOT IMPINGE UPON THE SEVENTH AMENDMENT RIGHT TO JURY TRIAL

The Seventh Amendment to the United States Constitution provides:

> In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no

> fact tried by a jury shall be otherwise re-examined in any Court of the United States, than according to the rule of the common law.

U.S. CONST., amend. VII.[8]

Consistent with its "historical objective," the Seventh Amendment operates to preserve "'the substance of the common-law right of trial by jury" as it existed in 1791 when the amendment was adopted. *Colgrove v. Battin*, 413 U.S. 149, 156 (1973) (quoting *Baltimore & Carolina Line, Inc. v. Redman*, 295 U.S. 654, 657 (1935)); *Parklane Hosiery Co., Inc. v. Shore*, 439 U.S. 322, 333 (1979) (The "'thrust of the Seventh Amendment was to preserve the right to jury trial as it existed in 1791.'") (citation and brackets omitted). To this end, the "ultimate determination of issues of fact" is a "jury" function preserved by the Seventh Amendment. *Ex parte Peterson*, 253 U.S. 300, 310 (1920). "The controlling distinction between the power of the court and that of the jury is that the former is the power to determine the law and the latter to determine the facts." *Dimick v. Schiedt*, 293 U.S. 474, 486 (1935).

But, importantly, the Seventh Amendment "was designed to preserve the basic institution of jury trial in only its most fundamental elements, not the great mass of procedural forms and details, varying even then so widely among common-law jurisdictions" in 1791. *Parklane Hosiery Co.*, 439 U.S. at 337 (internal quotations and citation omitted). The Seventh Amendment "'did not bind the federal courts to the exact procedural incidents or details of jury trial according to the

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[8] Only the first clause of the Seventh Amendment is conceivably implicated at all here (*i.e.*, "In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved"), and not the second clause, given that the PSLRA's pleading standard involves no judicial re-evaluation of any "fact tried to a jury."

common law in 1791, any more than it tied them to the common-law system of pleading or the specific rules of evidence then prevailing.'" *Id.* at 336-37 (citation omitted); *accord*, *Ex parte Peterson*, 253 U.S. at 309; *Fidelity & Deposit Co. of Maryland v. United States*, 187 U.S. 315, 319-21 (1902); *see also Walker v. New Mexico & So. Pac. R. Co.*, 165 U.S. 593, 596 (1897) (Seventh Amendment "does not attempt to regulate matters of pleading"). "Nor were 'the rules of the common law' then prevalent, including those relating to the procedure by which the judge regulated the jury's role on questions of fact, crystallized in a fixed and immutable system." *Galloway v. United States*, 319 U.S. 372, 390-91 (1943).

This Court's Seventh Amendment jurisprudence has never questioned the role of courts as gate-keepers who may dispose of cases *on legal grounds* – including grounds related to the legal insufficiency of plaintiffs' pleaded allegations or evidentiary proof – even though that necessarily prevented parties from ever getting to a jury. "No one is entitled in a civil case to trial by jury unless and except so far as there are issues of fact to be determined." *Ex parte Peterson*, 253 U.S. at 310. To be sure, the "ultimate determination of issues of fact" is a constitutionally preserved function of the "jury." *Id.* But nothing in the Seventh Amendment prevents Congress from establishing or modifying, and the courts from then applying, the rules and standards whose operation at the pleading stage (or otherwise) may lead to dismissal of claims on legal grounds that parties might otherwise wish to be tried to a jury.

Indeed, this Court's decisions have long recognized that, before any party can reach a jury, "there is a preliminary question for the judge" whether the alleged facts or evidence are legally sufficient to enable a jury to "properly proceed to find a verdict" in favor of the party "upon whom the onus of proof is imposed." *Improvement Co. v. Munson*, 81 U.S. 442,

448 (1871); *see also Pennsylvania Railroad Co. v. Chamberlain*, 288 U.S. 333, 343 (1933); *Gunning v. Coolley*, 281 U.S. 90, 94 (1930); *Fidelity & Deposit Co. of Maryland v. United States*, 187 U.S. at 319-21. In making such legal determinations, it is well settled that courts must take into account the legal rules and standards of proof governing the claims at issue, including any elevated standards imposed upon the party bearing the ultimate burden of proof at trial. *See, e.g., Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 252, 254-56 (1986).

Consistent with the Seventh Amendment, this Court has approved an array of legal and procedural mechanisms employed by courts to dismiss or otherwise dispose of claims in accordance with the governing legal standards – including motions for "summary judgment," *Parklane Hosiery*, 439 U.S. at 336 (citing *Fidelity & Deposit Co. of Maryland*, 187 U.S. at 319-21); motions for a directed verdict, *see, e.g., Galloway*, 319 U.S. at 388-93; and motions for judgment notwithstanding the verdict granted by trial or appellate courts, *see Weisgram v. Marley Co.*, 528 U.S. 440, 449-50 (2000); *Neely v. Martin K. Eby Construction Co.*, 386 U.S. 317, 321-22 (1967); *Baltimore & Carolina Line, Inc.*, 295 U.S. at 660-61. A motion to dismiss under modern-day practice – which is a "lineal descendant" of the "general demurrer" that existed under common-law pleading rules, 5B Charles Alan Wright & Arthur R. Miller, FEDERAL PRACTICE & PROCEDURE: CIVIL 3D § 1355, at 351-53 (2004); *see also Greene v. Louisville & I.R. Co.*, 244 U.S. 499, 502-03 (1917) ("motion to dismiss" is "equivalent to a general demurrer") – fits squarely within this category of legal and procedural mechanisms "developed since 1791 that have diminished the civil jury's historic domain [but] have been found not to be inconsistent with the Seventh Amendment." *Parklane Hosiery Co.*, 439 U.S. at 336.

Fidelity & Deposit Co. of Maryland is instructive. There, the Court held that Rule 73 of the Supreme Court of the District of Columbia did not violate the Seventh Amendment's right to jury trial, but rather merely "prescribe[d] the means of making an issue" prior to the accrual of any jury trial right. *See* 187 U.S. at 319-22. Rule 73 required parties in certain actions *ex contractu* to file sworn particularized affidavits, along with their pleas, which set forth distinctly the bases for their claims and defenses. When defendant's affidavit did not satisfy Rule 73's requirements (and instead generally purported to exercise the party's Seventh Amendment right to trial by jury), judgment was entered for plaintiff. On appeal, defendant argued that Rule 73, as applied, violated the Seventh Amendment. The Court held, however, that the rule prescribed the "means" by which parties are required to make "an issue" sufficiently to entitle them to proceed further and get to any jury. *Id.* at 319-20. The "right of trial by jury accrues," the Court explained, only once the "issue" has properly been "made as prescribed" by the governing rules. *Id.* at 320. Hence, the Court rejected the contention that the Seventh Amendment creates any "constitutional right to old forms of procedure," and confirmed that "Congress has [the] power to change" the rules at issue, including the means by which parties are required to "make an issue" sufficient to proceed further with their claims or defenses. *Id.* at 320-21.

Here, Congress in the PSLRA has amended the rules establishing what private securities fraud litigants must plead in order to "make an issue" sufficiently in their pleadings to get past a motion to dismiss. *Id.* A plaintiff's failure to plead with particularity facts sufficient to give rise to the Congressionally required "strong inference" of scienter operates to preclude the plaintiff from proceeding further with any securities fraud claim. *See* 15 U.S.C. § 78u-4(b). Indeed, Congress authorized a particular "motion to dismiss" in the PSLRA, and directed that federal courts "shall . . . dismiss"

complaints that, in the courts' assessments, do not satisfy the PSLRA's heightened pleading requirements. 15 U.S.C. § 78u-4(b)(3)(A). As a result, there simply are no issues of fact to be tried, because the plaintiff's complaint has been held *legally insufficient* under the governing standard established by Congress and applied by the courts. *See also Swierkiewicz*, 534 U.S. at 511 (On motions to dismiss under Rule 12(b)(6), "'[t]he issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims.'") (quoting *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974)).

In this sense, the Court is presented here with one of the many forms and details of pleading, and related legal standards, that do not genuinely implicate any jury trial right under the Seventh Amendment. Congress has elevated the pleading burden applicable to securities fraud plaintiffs based on a policy judgment that it has made, given its determination that the formerly more lax pleading rules and legal standards that previously applied to the federal statutory cause of action at issue had permitted abusive and vexatious litigation that was not in the Nation's best interests. *See* S. Rep. No. 104-98, at 8-10, *as reprinted in* 1995 U.S.C.A.N.N. at 687-89; H.R. Rep. No. 104-369, at 31-32, *as reprinted in* 1995 U.S.C.A.N.N. at 730-31; *Dabit*, 126 S.Ct. at 1510-11. This decision was entirely within the permissible province of Congress and does not run afoul of any rights protected by the Seventh Amendment. This is particularly so where, as here, Congress has legislated a heightened pleading standard with respect to a judicially implied cause of action that is solely a creature of federal statute, did not exist at common law, and could entirely be abolished by Congress without raising any Seventh Amendment issues at all.

In granting a motion to dismiss based on a plaintiff's failure to plead particularized facts sufficient to satisfy the PSLRA's "strong inference" standard, a court is not invading

any sole province of the jury as to determinations relegated exclusively to the trier of fact by the Seventh Amendment. The court is not making ultimate factual determinations. It is not making credibility assessments. Nor is it determining as a factual matter whether the defendant did, or did not, act with the requisite level of scienter. Hence, there is no "usurpation of the jury's role," *Makor Issues & Rights, Ltd.*, 437 F.3d at 602, when courts engage in the analysis required by Congress at the pleading stage under the PSLRA.

Rather, the court is assessing and determining – as a matter of law – whether the *quantum* of particularly pled facts alleged in the complaint (when taken together and assumed to be true) is sufficient to rise to the requisite *legal standard* established by Congress as the baseline that must be passed as a pleading matter to survive a motion to dismiss under the PSLRA. In determining that a given complaint fails to plead particularized facts sufficient to give rise to a "strong inference" that the defendant acted with the requisite scienter, and therefore must be dismissed, the court is performing a classic judicial gate-keeping function. It is testing the legal sufficiency of the complaint's allegations against the standard established by Congress. It is determining that the complaint fails to plead facts sufficient to allege the essential element of scienter in the manner dictated by Congress.[9]

The Seventh Circuit was apparently unwilling to accept and apply the PSLRA's "strong inference" standard out of allegiance to the usual Rule 12(b)(6) standard generally

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[9] In this sense, the court is merely applying the governing legal standard "bear[ing] in mind the actual quantum and quality of proof" required by Congress, while interpreting and applying the legal "benchmark" established in the PSLRA. *Anderson v. Liberty Lobby.*, 477 U.S. at 254-55 (emphasizing that the judicial gate-keeping function performed on summary judgment or directed verdict motions "does not denigrate the role of the jury").

applied by the courts, in which they give plaintiffs the benefit of all "reasonable" inferences from the complaint's well-pleaded factual allegations. *Makor Issues & Rights, Ltd.*, 437 F.3d at 602. But it is clearly a mistake to confuse traditional practice with constitutional mandate. Congress in the PSLRA explicitly raised the pleading hurdles for plaintiffs in securities fraud cases. It changed the typical rules that the courts are accustomed to apply. The Seventh Circuit committed clear error by interpreting the PSLRA's "strong inference" standard as no different than the former pleading interpretation rules that Congress altered by enacting 15 U.S.C. 78u-4(b). Certainly nothing in the Seventh Amendment commands courts to disregard the actual and heightened pleading rules imposed by Congress under the PSLRA, and to adopt a watered down construction that effectively nullifies the heightened standard and returns it to the former standard Congress plainly intended to replace.

When undertaking the analysis required under the PSLRA, courts are not engaging in any impermissible weighing of the evidence to determine matters of fact; they are engaging in legal reasoning to assess and evaluate whether the particularly pled facts alleged in the complaint are *sufficient as a matter of law* to surpass the governing standard established by Congress. *See, e.g., Pirraglia*, 339 F.3d at 1187. To the extent that making this legal determination involves any "weighing" of the complaint's particularly pled factual allegations to determine if they surpass the legal standard established by Congress in the PSLRA, the Seventh Amendment does not prohibit it. *See, e.g., Galloway*, 319 U.S. at 390 (emphasizing that, even "in 1791," the "jury was not absolute master of fact": "courts . . . weighed the evidence, not only piecemeal but *in toto* for submission to the jury," pursuant to various gate-keeping legal and procedural mechanisms).

Moreover, it proves too much to posit that the Seventh Amendment mandates that Congress may *never* adopt any legal standard – at the pleading stage or otherwise – that is higher than a mere "reasonable" inference standard. What the Seventh Amendment preserves is the basic institution of jury trial only in its most fundamental elements, *Parklane Hosiery Co.*, 439 U.S. at 337, which ensures that the "ultimate determination of issues of fact" shall be made "by the jury." *Ex parte Peterson*, 253 U.S. at 310. The Seventh Amendment does not establish any "reasonable" inference standard as an irreducible constitutional floor and ceiling, just as it does not mandate any particular pleading rules, evidentiary standards, procedural requirements, or standards of proof. *See, e.g., id.* at 309-10; *Galloway*, 319 U.S. at 390-91; *Fidelity & Deposit Co. of Maryland*, 187 U.S. at 319-21.[10]

In short, a court's determination of the legal question of what quantum of particularly pled facts gives rise to a sufficiently "strong" inference of scienter, 15 U.S.C. § 78u-4(b)(2), does not invade the jury's fact finding function preserved by the Seventh Amendment. It is a threshold legal determination for the courts, akin to the sort of legal determinations this Court has long approved without running afoul of the Seventh Amendment.

A defendant who acted innocently, or even just negligently, has not violated the federal securities laws. *See Ernst & Ernst*, 425 U.S. at 193; *Huddleston*, 459 U.S. at 382-83. Under the PSLRA, if the adverse inferences drawn from the particularly pled facts in the complaint do not *tend to*

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[10] These are policy matters for Congress to determine, especially with respect to particular federal causes of action. *See, e.g., Galloway*, 319 U.S. at 395 (emphasizing that the "standards" governing what quantum of proof is legally sufficient involve questions "to be worked out in particular situations and for particular types of cases").

exclude the defendant's having acted with a non-culpable mental state, then Congress's "strong inference" standard in the PSLRA should not be met as a matter of law. In that circumstance, the complaint's particularly pled facts – even when assumed to be true on a motion to dismiss – would simply be too weak, tenuous, and speculative to establish a sufficiently "strong inference" of scienter and, therefore, would be legally insufficient to survive a motion to dismiss. Such a construction of the PSLRA's heightened pleading standard is consistent with other decisions of this Court on motions to dismiss or for summary judgment and, thus, would plainly comport with the Seventh Amendment. *See, e.g.*, *Matsushita Elec. Indus. Co.*, 475 U.S. at 587-88 (summary judgment properly granted defendant where plaintiff's evidence did not "tend to exclude" possibility that defendants acted independently, and thus lawfully, rather than collusively, and thus illegally under antitrust laws; "antitrust law limits the range of permissible inferences" that may be drawn "from ambiguous evidence"); *Associated General Contractors*, 459 U.S. at 535-43, 545-46 (Rule 12(b)(6) motion to dismiss properly granted and complaint's allegations held "insufficient as a matter of law" where connection between alleged antitrust violation and plaintiff's alleged injury was too "indirect," "remote," "tenuous and speculative").

CONCLUSION

For the foregoing reasons, this Court should reverse the judgment of the Seventh Circuit, and remand for further proceedings consistent with the Court's opinion.

Respectfully submitted,

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